

Small and Medium Enterprise Development in Georgia: Assessment and Recommendations for USAID's Strategy

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PREFACE

This study was undertaken in Georgia under the USAID Support for Economic Growth and Institutional Reform Project—General Business Development, Trade and Investment, contract PCE-I-00-98-0017-00. A joint assessment team from Development Alternatives Inc. (DAI) and PricewaterhouseCoopers L.L.P (PwC) carried out the assignment during April and May 1999. The team consisted of Paul Bundick (team leader), Brandon Barnes and Mary Miller from DAI and Dennis Smyth from PwC. This report is a product of our collective efforts.

In carrying out the assignment, the Team received overall guidance from the USAID Mission. During the course of the work, the Team met several times with Michael Farbman (Director) and Alonzo Fulgham, and more frequently with Amy Heinen and Tamara Sulukhia. The Team would like to thank the USAID Mission for their support during the assessment. They, at all times, supported an independent inquiry and encouraged us to be innovative, take a “fresh look” and try to understand the issues as the Georgian business community actually sees them. We have taken their counsel seriously and, as a result, hope our findings will better inform the Mission’s strategy development for the private sector in the months ahead.

The Team would also like to thank the hundreds of Georgian professionals and business people who gave up their time to meet with us and share their thoughts and feelings. Through the work of excellent translators, we were able to better understand the constraints and opportunities facing the emerging business community as they struggle to succeed in a difficult environment. We also appreciate the excellent cooperation from dozens of expatriate advisors working for donor organizations, USAID contractors and numerous NGO managers who found time to meet with us. Special thanks are extended to both the International Executive Services Corps and CARE Georgia, which provided the Team with a great deal of important information, which greatly enriched the report.

Finally, the Team would like to express its sincere appreciation to the Georgian people for the hospitality shown to us during our stay. It is our sincere hope that this report will make some contribution towards the development of the private sector in Georgia as a critical step in improving the lives of its citizens.

The Assessment Team

**SME DEVELOPMENT IN GEORGIA:
ASSESSMENT AND RECOMMENDATIONS FOR USAID’S STRATEGY**

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ASSESSMENT AND RECOMMENDATIONS FOR USAID'S STRATEGY

Executive Summary

Introduction

The 1990s have been challenging times in Georgia. The formidable work of creating a new nation after independence was made even more difficult by the eruption of civil conflict and staggering inflation rates. Understandably, initial donor efforts focused on humanitarian relief and stabilization of the macroeconomic situation, along with key legal and regulatory reforms. By and large, the work of these reforms has been effective, although many problems still remain.

While Georgia enjoyed a good macroeconomic performance in the past few years, the benefits of stringent, corrective economic policies have not been reaching the average Georgian. Though one can see pockets of affluence, the population in general has not yet enjoyed the benefits of reform and the new market-oriented economy. There is still widespread unemployment and poverty.

This situation has led USAID to adopt a new strategic direction. The priority now is to bring the benefits of the market economy to a broader section of the population. This will require a shift in programming, from legal and regulatory reform to interventions, aimed at building key private sector institutions, enterprise development and the major challenge of creating new jobs. The underlying assumption of USAID is that most of the needed job creation will come from the growth and development of the small and medium enterprise (SME) sector.

Accordingly, this study was commissioned to:

- Analyze constraints and opportunities facing the private sector (particularly for SMEs), and
- Recommend additions, refinements, and modifications to the new USAID strategy now being designed to accelerate private sector development and employment creation.

One of the primary concerns of this study was to collect new information and not recycle what is already known. Effort was made to talk directly with businesses, especially outside of Tbilisi, about their needs, constraints, limitations and opportunities. The Assessment Team collected information directly from businesses through:

- Focus groups – seven in all, in Kutaisi, Batumi, Gori, Tbilisi, attended by more than sixty businesses in total; and
- Direct interviews with more than twenty firms.

Additionally, the Team talked to a wide range of donor organizations, banks, business support organizations and other service providers. The information that follows is a brief summary of the Team's findings and recommendations.

Overview of Constraints: SME Perspectives

The major constraints cited by businesses are:

Taxes and Customs –

- Collectively too high
- No services received in return from government
- Harassment from tax inspectors, including solicitation of bribes
- Misinformation and lack of information about amount of taxes owed – Tax calculations are arbitrary.
- Competition from smuggled goods – lower cost because import duties have not been paid, no protection from these cheap imports

Government and Regulations –

- Lengthy business registration process
- Lack of clarity in process
- Corruption, bribe solicitation
- Arbitrary enforcement of laws

Finance –

- Capital largely comes from savings, family, and friends.
- Mistrust of banks - SMEs generally do not want bank loans because:
 - Concern about ability to repay (concern about business performance, due to both external pressures and management abilities)
 - High interest rates – 24-60% per annum interest is charged
 - Lack of term loans – Financing is not available for equipment acquisition and capital improvements.
 - Collateral – high collateral requirements, typically personal assets (gold and residences) rather than business assets
 - Bribe-taking by bank officials
- Firms are interested in getting foreign investors (and buyers) but have little notion of how to go about doing this.

Other –

- Outdated, worn-out equipment – There is a particular need in the agro-processing industry for packaging and labeling equipment.
- Lack of consumer purchasing power
- High operating expenses – because of collective level of taxes, customs, bribes; competition may not be paying as much of these, therefore can operate more cheaply.
- Lack of information about
 - Markets, both domestic and foreign
 - Law and government relations
 - Suppliers
- Loss of traditional CIS markets
- Difficulty and cost of procuring raw materials

The Team observed a tendency of firms to regard all business problems as having external origins. There was little acknowledgement of internal limitations, lack of experience, and little concept of how to operate in a market economy. For instance:

- No serious investigation of potential buyers
- Concept that price and quality are the only possible competitive factors

- Notion that competition only consists of direct competitors (E.g., a producer might not consider a product produced elsewhere and sold in same market as competition; general merchandisers also sell specialty products, which may not be acknowledged by specialty stores.)
- Advertising is often viewed as trying to fool or deliberately mislead the buyer.
- Little strategic thinking in relation to market development

An important finding was that many managers of SMEs are almost hostile to any non-financial assistance. Business plans, for instance, are regarded only as a ticket to getting credit, and are not used for any planning purpose. SMEs also see little value in joining business associations and chambers of commerce, because they do not see benefits from dues paid, and are concerned that organizations may only be the platform for promoting the organizer's political agenda.

There is some fluidity and growth in the SME sector that can be observed. For instance, somewhat larger, more established firms are less likely to be asked for bribes by banks. Apparently, banks and bankers appreciate their business. There is also some individual progress by firms in differentiating themselves, through advertising, merchandising, and offering additional services such as credit terms. Finally, businesses want to keep a low profile, so that their success will not be noticed and exploited. This accounted for some firms' decisions not to: keep monies in a bank, seek bank loans, or advertise.

Financial Sector Constraints

The banking industry is extremely weak, and is not performing the intermediation function necessary for SME development. There is a great mistrust of banks, and reluctance to keep deposits in banks, because of the risk of bank failure, historic inflation, the attaching and seizing of funds on deposit by the tax authorities, and the lack of liquidity in the banking system. More than half of the loan funds in the banking system actually come from donor lines of credit in the banks, rather than from deposits.

Problems in the banking system are being addressed through extensive donor work with the central bank on banking law, capital requirements, and institution of supervisory and regulatory policies and procedures, but this process will take a long time. EBRD and TACIS-funded consultants are doing additional work in credit policy, asset and liability management, and general bank management at the bank level. The Shorebank programs at TBC Bank, and available to the other banks, are particularly noteworthy as good demonstration models. The Team strongly encourages continuation of this work, as ultimately there is no substitute for a strong banking system that can provide the loan funds needed by businesses for growth.

The Microenterprise Sector

The microenterprise sector in Georgia is particularly significant because of the number of people who have lost jobs because of the closing of state-owned industries, or who are Internally Displaced Persons (IDPs) resulting from the civil war in Abkhazia. USAID has supported a number of microenterprise projects, in order to increase income generation for the participants. The projects are predominantly, or even exclusively, focused on women. While some microenterprises provide services or are in very small-scale production, the great majority are market traders, so the microfinance projects generally are doing volume group lending in areas with a large bazaar. FINCA, USAID's primary microenterprise partner, is a

well-run, disciplined program that USAID should continue to support, particularly in expansion of services to western Georgia. Constanta's program is also well run and should be considered for future support.

Business Support Organizations and Associations

USAID has found that in central and eastern Europe and in the NIS countries, building institutional services for SMEs through supporting the creation and development of business support organizations and services has been an effective way to assist SME growth. In Georgia, however, there is very little demand for traditional training and advisory services. This is not to minimize the fact that Georgian businesses greatly lack the management skills that are needed to operate in a market economy. However, the business owners are most emphatic that they are not interested in such assistance, unless they can see an immediate benefit or payoff. The traditional approach of supporting business support organizations is not likely to be a useful way to assist SMEs in Georgia at this time.

TACIS and other donors have given considerable support to the development of business support centers and other consulting organizations, which are now moving away from donor funding and are trying to operate on a self-sufficient basis. These advisory firms are generally targeting their services to clients with an ability to pay, particularly foreign companies that are considering investments in the country.

Many SMEs regard business associations as not being useful. Businesses are required to pay dues to the chambers of commerce, but do not see any services provided in return. Some associations seem to easily turn into political parties, often supporting the exclusive interests of the association promoter. There is an interest in developing business clubs, but entrepreneurs want the setting to be informal and private so that real issues can be discussed. While association development has also been a centerpiece of USAID's development strategy in the CEE/NIS region, an activist top-down organizing strategy would not be well received in Georgia at this time. A better approach is to "spark" demand and support local organizations and groups, which respond on their own initiative. Businesspeople need time to evolve their associations in response to their particular needs, rather than being the object of someone else's organizing.

Policy and Regulatory Framework

As noted before, substantial work has been done in Georgia in areas that will affect SMEs, including banking reform, accounting reform, tax reform, and land reform. At a policy level, the most important agenda item is the pervasive corruption found in the government and in society in general. This corruption, reflected in the bribe seeking by tax and customs inspectors and business registration offices, is the single greatest problem that SMEs have to deal with in trying to control costs and conduct business. Additionally, while the government has been approving what are generally regarded as "good" laws, these are often not being implemented. Further, there is little dissemination of information about legal and regulatory changes, so SMEs, especially those outside of Tbilisi, are vulnerable because of their lack of knowledge and information about the latest laws, regulations or administrative decrees.

RECOMMENDATIONS

Based on this analysis, the Assessment Team recommends the following to USAID.

- 1. Focus greatest attention on small and medium sized businesses, to start addressing the immediate need for job creation.**

To have the most impact in creating jobs and increasing income for average Georgians, USAID should give the highest priority to the small and medium sector of the economy. Not only is this sector traditionally the most successful at stimulating employment, technical assistance to SMEs has been one of USAID's strengths in the NIS region.

- 2. Focus SME development efforts outside of Tbilisi, especially in western Georgia.**

Tbilisi and the surrounding areas are the current focus of donor assistance programs. Western Georgia contains the country's second largest city (Kutaisi) and is one of the poorest regions in Georgia. USAID can have significant impact if it focuses its efforts on creating jobs for the thousands of unemployed in this region. Such an effort would also be benefiting many Internally Displaced Persons (IDPs) from Abkhazia who are concentrated in Western Georgia.

- 3. Address the credit and capital needs of SMEs, particularly for long term financing.**

One of the largest constraints to small and medium enterprise development is the difficulty in accessing credit, especially for long term financing. In order to address this issue, the Team is recommending the following options.

- Option 3.1 Establish an SME equity fund based in Kutaisi to provide equity and longer term financing coupled with "hands-on" management and marketing assistance.

Based on the success of equity funds that have been implemented in other parts of the region, USAID could implement a similar model in Georgia. This equity fund would provide the much needed financing required by most firms in Georgia, while at the same time providing "hands on" technical assistance to firm managers. This deep mentoring assistance will furnish the enterprises with the skills required to operate in a market environment and allow the firms to become positive examples for the rest of the country.

- Option 3.2 Develop a leasing product to respond to long-term financing needs of SMEs.

The ability to obtain long-term financing for equipment and other fixed assets is extremely difficult in Georgia. Leasing provides companies with alternative means to obtain these assets. The most likely leasing opportunities will be in technology for packaging equipment or transportation equipment to improve distribution channels.

- Option 3.3 Continue targeted assistance to develop the banking and financial sector.

The best method to improve access to credit is to have a robust, well-functioning banking sector. While this will take time to develop in Georgia, USAID should continue its work in banking regulation and supervisory law.

4. Postpone development of business service centers and additional development of management consulting capacity at this time.

While business service centers and other institutional business providers have proven to be successful in the region, SMEs in Georgia have shown little interest in buying non-financial assistance from these centers. Until this demand can be built up, USAID should postpone focusing its efforts on institutional development and instead concentrate on improving business skills through other methods.

Option 4.1 Sponsor a new approach to business skills training.

There is a fundamental lack of basic market-oriented business skills among the majority of firms in Georgia. The problem is that the enterprises themselves do not recognize this lack of skills, rather, they have the attitude that training and non-financial assistance is useless. Instead of offering the standard courses on basic business topics, USAID should sponsor a program of highly specific, demand driven courses that will be well received, provide important business information, and spark new demand for other, deeper kinds of training and assistance.

Option 4.2 Create public awareness campaigns around critical business topics – Knowledge is Power.

A large constraint to all Georgian businesses, especially the ones outside of Tbilisi, is the lack of information on critical issues such as tax calculation and tax reform. USAID should undertake a social marketing campaign to disseminate information on key business topics to as wide an audience as possible. The means of this information campaign could be by TV, radio, print, or other methods, but the most important objective is to ensure that as many people as possible understand important issues.

Option 4.3 Explore feasibility of a new market development initiative for SMEs, especially in the food and beverage sectors.

One of the greatest deficiencies among SME managers is the lack of understanding of marketing and market development. USAID should explore a new initiative in market development, especially in the agribusiness sector, where Georgia seems to have a competitive advantage. Such a program would work directly with firms to create new markets and help to develop exports.

5. Continue to encourage “islands of innovation” and emerging voluntary associations but postpone major association building initiatives.

Most Georgian business people have little appreciation for associations. Until a demand for, and recognition of, the value of associations develops, USAID should postpone major initiatives in building associations. However, it should continue to support their evolutionary development through innovative grants and targeted assistance to member-driven groups,

which form on their own initiative. Selected professional associations may offer the best partners for building associations, at least in the short term.

6. Continue support to existing microenterprise finance projects, and encourage expansion outside of Tbilisi.

The microenterprise programs that USAID is currently supporting have proven to be effective and successful. The Mission should continue to support the microenterprise sector through these programs and consider supporting others, some of which are highlighted in this report. It should also encourage microfinance programs to expand further into other regions of the country. In addition, experimentation in delivery of microfinance should be considered in order to reach beyond the market traders who are currently the focus of the programs.

SME DEVELOPMENT IN GEORGIA:

ASSESSMENT AND RECOMMENDATIONS FOR USAID'S STRATEGY

SECTION 1 INTRODUCTION AND BACKGROUND

1.1 Overview of the Situation in Georgia

The past ten years have been times of tremendous upheaval for Georgia, including the breakup of the Soviet Union, the civil war and continuing ethnic tensions in Abkhazia and Ossetia, and ruinous inflation rates. All of these factors contributed to a delay in the transition from a command to a market economy, and USAID and other donors initially focused efforts on humanitarian concerns to relieve immediate suffering. In the past few years, USAID has concentrated on policy reforms that have assisted in stabilizing the macro-economic environment. It also has helped introduce banking reform, tax reform, regulatory assistance, land tenure reform, adoption of international accounting standards, and a host of other measures that should create a more conducive operating environment for Georgian businesses. While these continue to warrant significant attention, the concern is that this policy level work has not had significant impact on the majority of Georgians. The gap between the relatively affluent and the poor has widened, and there are excessive rates of unemployment and widespread poverty.

1.2 Strategic Priorities of USAID

In response to the above-mentioned situation, USAID/Georgia is in the process of designing its economic development strategy for the next three to five years to assist the development of private enterprises. The Mission is drafting a Strategic Objective, "Accelerated Growth and Development of Private Enterprise." The intended result of this new strategy is to create new jobs and bring the benefits of market-oriented reforms to a larger portion of the Georgian population.

While much of the strategy is nearly in place, its finalization is awaiting a more comprehensive assessment of the constraints and opportunities facing the private sector. Given the emphasis on job creation and extension of benefits to larger numbers of Georgians, questions still remain about specific priorities, technical approaches, institutional vehicles, and so forth, to which USAID should focus its efforts over the next half decade. An analytical review of the small and medium-size enterprise (SME) and microenterprise sectors is, therefore, opportune and timely.

1.3 The SME and Microenterprise Sectors in Georgia

The definitions of micro, small, and medium size business in Georgia are not fully established yet, so a brief discussion of the size of the businesses to be assisted is in order. The definition of the SMEs in Georgia used by the Government of Georgia State Department of Statistics follows the European Union's size standards, except in defining large firms.¹

¹ The European Union defines the break between medium and large size firms at 250 employees.

The table below shows firm size, and the number of firms in each category, per the most recent available information²:

<u>Firm Size</u>	<u>Number of Firms³ Registered</u>	<u>Percentage</u>
Very Small Firms, 1 – 9 Employees	46,138	81.6%
Small Firms, 10 - 49 Employees	7,372	13.0%
Medium Firms, 50 – 199 Employees	2,376	4.2%
Large Firms, More than 200 Employees	656	1.2%
Totals	56,542	100.0%

It is also interesting to note that over 50% of firms are retailers or wholesalers of trade goods. Certainly there is a heavy concentration of firms at the small end of the scale. Not surprisingly, over 50% of the 56,542 registered companies in Georgia are retailers or wholesalers of trade goods and 95% of these trading companies (more than 27,200) are classified as very small (micro). Certainly there is a heavy concentration of trading companies at the smaller end of the enterprise size spectrum. Interestingly, small and very small industries make up 92% of the 7,800 registered industries in the productive sector, with only 156 of these being categorized as large with more than 200 employees. Microenterprises and SMEs make up 99% of the industries in Georgia. A more complete breakdown of enterprise characteristics can be seen in Appendix A.

The draft “Law of Georgia on Support of Small Enterprises” calls for more distinction among types of business, indicating that its target constituencies will include firms of the following size.⁴ By definition, banking, financial services, and insurance businesses will not be considered small businesses.

<u>Business Type</u>	<u>Upper Limit on Number of Employees</u>	<u>Upper Limit on Annual Revenue</u>
Industry	40	GEL 400,000
Construction	30	GEL 300,000
Transportation and Telecommunications	25	GEL 200,000
Agriculture	20	GEL 150,000
Wholesale and Retail Trade	15	GEL 50,000
Education, Health, Culture	30	GEL 60,000
Other	15	GEL 60,000

The Government of Georgia’s definition of “very small businesses” (i.e., fewer than 10 employees) fits the global USAID definition of microenterprise. For analytical purposes in this study, microenterprises were approximately distinguished from small businesses by the following characteristics:

² Information from the Government of Georgia State Department of Statistics, made available to the Assessment Team by the Georgian Opinion Research Business International (GORBI).

³ The total number of firms includes both private and state-owned enterprises, of which 90% are private enterprises.

⁴ At the time this study was prepared the exchange rate of the Georgian lari (GEL) ranged from GEL 1.90 – 2.18 to US \$ 1.

- Microenterprises were most typically market traders, whose place of business was a rented table in a bazaar. Small businesses were more likely to have a store location.
- Microenterprises were more likely to be self-employed people, with (at most) family members working with them. Employees of small businesses included non-family members.
- Activities of small businesses created employment, whereas microentrepreneurs only generated income for themselves.
- Small businesses were more likely to be registered, while microbusinesses mostly operate on an informal basis.
- Small business owners were more likely to have assets that could be used as collateral for banks, such as gold and residences.

Finally, the scope of work for this assessment indicates that USAID/Georgia is interested in assisting those businesses that employ up to 50 people, and have assets of up to US\$250,000. It is assumed that the growth of such enterprises will make the greatest contribution to employment and foreign exchange generation.

1.4 Objectives of the Study

The assessment had two basic objectives:

- To analyze the constraints to, and opportunities for, private sector development in Georgia, taking into account the immediate need for employment creation and increasing incomes of those who have not yet benefited from the recent economic growth.
- To recommend additions, refinements and/or modifications in USAID's private sector strategy required to accelerate private sector development and employment creation.

1.5 Methodology and Approach

USAID indicated that it wants to focus on SME development directly at the local and individual level, rather than continuing to stress policy issues. For this reason, it seemed important that this study highlight the businesses themselves, their perceptions of the constraints and problems that they face, as well as the Assessment Team's evaluation of these factors. Businesses were contacted in two ways:

- Direct interviews with some twenty firms, with introductions provided by banks, business centers, local contacts, and IESC contacts. Most of these interviews were conducted with firms outside of Tbilisi.
- Seven focus groups assembled and questioned by Georgian Opinion Research Business International (GORBI). These focus groups took place in Kutaisi, Batumi, Tbilisi, and Gori. Each focus group included eight to twelve businesses. Team members were present for six of these sessions, to hear the complete discussion of issues through simultaneous translation.

Background and status interviews were also conducted with:

- USAID, and its private sector consultants
- Other donor organizations, such as the World Bank, EU/TACIS, and EBRD

- Current and former USAID-supported programs, including ACDI/VOCA, IESC, Shorebank Advisory Services, FINCA, Eurasia Foundation, Horizonti, and CARE
- International and local NGOs such as Save the Children, Constanta, and Women in Business
- Government of Georgia representatives
- Commercial banks in Tbilisi and other cities
- Business assistance centers in Tbilisi and other cities
- Chambers of Commerce in Tbilisi and other cities

The work also included an extensive literature collection and review. Lists of all sources and contacts are contained in appendices to this report.

The study has gathered perceptions of entrepreneurs, collected data on the strengths and weaknesses of enterprises at various levels, and evaluated the threats and opportunities presented by the business environment. Our primary task has been to understand, in real terms, the challenges facing micro, small and medium enterprises in Georgia. Based on this deeper understanding, we have recommended ways in which these challenges can be overcome and turned into opportunities for growth. In each case, however, the constraints have been related back to the enterprise level and the experience of the entrepreneur. The approach was designed to be practical in both its problem analysis and recommendations for action.

1.6 Organization of the Report

Since entrepreneurs and SMEs are the focus of this report, the next section describes the constraints and problems that they face. This is followed by discussions of the financial and non-financial conditions and support available to SMEs in Georgia, and a specific report on support for the microenterprise sector. Next is commentary on policy as applies to SMEs, plus brief presentations on other issues and findings. The Team's recommendations are in the final section.

SECTION 2 OVERVIEW OF CONSTRAINTS: SME PERSPECTIVES

2.1 Profile of Firms Interviewed and Focus Group Participants

In order to focus on the constraints of the enterprises themselves, the Assessment Team conducted individual interviews with firms and also contracted GORBI to conduct focus groups in Kutaisi, Batumi, Gori, and Tbilisi. There were sixty-six participants in the focus groups representing a variety of sectors in the Georgian economy. For example, from the service sector, there were hotel managers, café owners, pharmacies, and others. In processing, the focus groups included, for example, companies involved in bottling and food processing, and in industry, there were construction supply companies and clothing manufacturers. In addition, some participants were involved in wholesale and retail trade⁵.

Men owned about 85% of the companies represented in the focus groups. Most of the firms were relatively new, with more than half created since 1996. Both small and medium companies were represented, although the concentration was on the smaller side since 75% of the participant enterprises had 20 or fewer employees. The firms that were visited independently of the focus groups were similar in characteristics although the Team tried to expand its knowledge by visiting some larger firms and some agricultural enterprises.

The small and medium firms in Georgia are more frequently privatized state companies (or were a part of a former state-owned enterprise) than start-ups founded by entrepreneurs. The owners of these firms typically were former managers of state-owned businesses, and remained in control after privatization. Frequently, these businesses are operating at very low capacity, or are non-functioning, and the owner/managers are still focused on production rather than on sales and marketing. For example, operations were typically described in terms of plant capacity instead of annual revenue or market position. Generally, it appears that the successful businesses are more frequently startups rather than formerly state-owned enterprises.

Businesses in Georgia tend to be overly diversified. For instance, one business owner, in this case a start-up, was simultaneously seeking financing for a fish farm, a poultry business, and a fodder processing plant. It appeared that any single one of these businesses might be successful on its own, if all the owner's resources had only been devoted to one operation. Instead, scarce savings had been spread across all the operations, and none were functioning. In another example, Team members interviewed an over-diversified entrepreneur whose main interest was a stone-cutting factory, but who had also started a car wash and a retail store.

All of the businesses were asked about their principal problems. Generally, non-operating businesses had no response to this beyond citing a need for financing. Problems cited by operating businesses were more wide-ranging, but still were more likely perceived to be factors outside the business rather than internal management problems.

The next sections discuss the businesses' cited problems and concerns. Taxes, customs, and enforcement problems were most common, followed by the need for funding. These two categories are laid out in separate sections, followed by a discussion of other problems described by the businesses. Finally, there is a presentation of apparent internal management problems and limitations that might be addressed by SME technical assistance.

⁵ See Appendix B for a list of focus group participant characteristics.

2.2 Business Constraint – Taxes and Customs

When asked about the greatest problems facing their businesses, a majority of managers emphatically complained of taxes as being their primary concern. The most common protest is the general statement that “the taxes are too high”, and while this may be true to an extent, there are other problems with the tax system besides the rates. Presently, all small and medium enterprises are responsible for the following taxes, in addition to personal income taxes: value-added tax (VAT); profit tax; social taxes; and property tax. In addition, if the enterprise obtains supplies from foreign countries or is involved in any sort of importing, it is also responsible for customs duties. There are also local taxes⁶ collected by the regions, and depending on the product, excise taxes may also be applicable.

Of the enterprises interviewed, a great deal of them stated that they would be willing to pay all of their taxes, but at the moment the burden is just too much. Therefore, they are being forced to take measures to avoid these added costs to their production. Georgian businesses are quite open and honest about evading taxes because they feel that it is the only way they can survive in the present marketplace. For instance, many firms sell a portion of their products “off the books” in order to avoid paying all VAT tax, which is currently set at 20%.⁷ In addition to the financial burden, small and medium business owners are fed up with taxes because they see no return for their contributions. They feel as if they are paying large amounts to the state budget, but receiving no services in return. As one entrepreneur stated in the focus groups, “Taxes should reflect business realities, not just the need for government revenue.” This sentiment is very widespread.

Besides the actual rates of the taxes, there is a great resentment among small and medium enterprises of the harassment they receive from the tax inspectors. Some businesses are visited several times a month by several different inspectors, and smaller firms especially feel they are targeted more than larger ones. These firms end up being asked for and paying bribes in order to be left alone. Part of the reason for this harassment is that the government tax inspectors receive very low salaries (GEL 35 per month), and many have not been paid for several months. Therefore, they must supplement their income through these illegal pay-offs. The enterprise managers, who are unclear of the details of the tax law, would rather just pay the bribe than raise the matter to a higher level, where they feel they would be unsuccessful anyway. (In their view, the amount of the bribe is probably lower than the tax bill.) A clearer understanding of the law by enterprises, a consolidation of collection efforts, and a concerted undertaking to have well-trained and well-paid inspectors could reduce this corruption and the unreported costs of doing business in Georgia.

For enterprises that are importing supplies or goods, customs duties are another hindrance. With the customs tax, the customs service fee, and the VAT, some rates are as high as 34.7%, and this added cost makes a firm’s product too high-priced when competing with other firms. SMEs also are extremely concerned about the apparent high number of illegally smuggled goods that are entering the country, especially from countries such as Turkey and Russia. Georgian enterprises feel that they are put at an unfair disadvantage having to compete with

⁶ Local taxes are: tax on entrepreneurial activity; tax on car parking; local symbolic utilization tax; tax on gambling resources; tax on resorts; hotel tax; and advertisement tax

⁷ Further, there appears to often be a misunderstanding that VAT tax on purchases of inputs can be offset or recouped.

cheap imported goods that are dumped on the market without the extra customs duties having to be figured into the price.⁸

2.3 Business Constraint - Government and Regulations

Small and medium enterprises throughout Georgia all complain that the state hinders their businesses. A new firm must file as many as 14 different documents in order to become officially registered, and as with the tax authorities, bribes are common along the way. Many firms do not have a clear understanding of all the laws and regulations required for doing business and, as a result, are subject to intimidation and bribery from several government ministries who arbitrarily enforce certain laws. As one business owner stated in the focus groups, “we have no understanding of the rules of the game”.

Among the business community, there is a view that corruption pervades all branches of government. From experience, business owners feel that the only way to accomplish anything when dealing with the authorities is to pay bribes. The problem of this corruption cannot be overstated as it is one of the largest constraints to a thriving, market-driven economy. Transparency and clear explanations of rules and regulations need to be encouraged and enforced at all levels of government in order to allow the market to function properly. Even though a majority of businesses feel that recently there have been good laws passed by Parliament, they feel that there is a large gap between the written law and how it is actually enforced.

2.4 Business Constraint – Need for Finance

Another significant complaint from SMEs concerned the lack of availability of finance. Focus group respondents generally indicated that they did not have bank loans, although they were more likely to have received credit from a bank if they were larger or had been in business longer. Small businesses were reluctant to borrow from banks, citing the following reasons:

- Concern about success of business ventures and the use of loan proceeds. SMEs were not sure whether their business, or expansion of the business, was likely to be successful (because of the poor economic environment, and other perceived constraints facing their business), thus were worried about taking loans that they might not be able to repay. This even extended to concern over whether trading goods inventory purchased with bank loan proceeds could be resold.
- High interest rates. The lowest rates cited for loans by borrowers, and by the banks themselves, is 2% per month, and such rates range as high as 5% per month. These rates are prohibitive for any sort of term lending, and are only warranted for brief trading loans.
- Lack of long term loans. While short term trading loans are being granted to some extent, term loans that are necessary for equipment finance and capital improvements are not available, and the high interest rates would, in any case, make the cost prohibitive.
- Concern about foreclosure on collateral. Generally, residences and gold are the items accepted as collateral. These are personal assets (SMEs are less likely to own business real estate, thus would be pledging residences as collateral) and foreclosure would essentially wipe out any business owner’s personal net worth.

⁸ A British company, ITS, has been contracted to handle Georgia’s customs and train its officials beginning June 1, 1999 so this should significantly decrease the number of illegal imports.

The SME mistrust of banks extends past the specific complaints listed above, indicating that there is not likely to be much confidence in banks anytime soon. Everyone seemed to have a story about bank loan officers asking for bribes (ranging from 20% to 40% of the loan amount) in advance to consider loans or taking a percentage of the loan proceeds. There were even indications that the loan officer or the bank expected to get a percentage ownership position in the business. It should be noted that bank corruption is a great subject for rumor and innuendo⁹, but there are enough first person stories to confirm that this is not a limited problem. Businesses generally indicated that it was necessary to have a connection into the bank to get a loan, for which they would pay a fee. These bribes and other payments greatly raise the effective costs of borrowing.

Several of the small business owners in cities outside of Tbilisi were concerned that there were no banks based in their city. This suggested that Tbilisi-based bankers were ignoring the region, thus credit was less available. One respondent indicated that a local bank officer expected a fee to even pass a loan application on to Tbilisi for review.

Another concern expressed about having bank loans, or substantial monies on deposit, was attracting unwanted attention and wishing to keep a low profile. This included interest from the tax authorities, who can place a lien on accounts fairly easily¹⁰, as well as from other parties who might and pressure the business for either legitimate or illegitimate payments.

The businesses maintain current accounts with banks, apparently as a channel for paying taxes, but do not otherwise keep substantial account balances. The banks' lack of liquidity causes a problem for businesses. One focus group member described an experience of depositing funds intended for payroll in the bank (the deposit would essentially record the amount for tax purposes) but then being unable to immediately withdraw the same cash to pay salaries.

In fairness to the banks, some SMEs did acknowledge that the banks face substantial problems in their own development. Information brought out in focus groups included the fact that some bank salaries are very low, hence bank officers would be looking for payoffs as a needed supplement to compensation. One participant described, with nods of agreement from the others, that 'there had been a lot of bank failures and charged-off loans, therefore the banks' risk-averse behavior was understandable'. In general, medium-sized businesses with more operating history get a better reception from banks, and were more likely to have business loans. They also seem to be less likely to be asked for bribes, suggesting that the banks are competing for proven clients, or those with strong political connections.

Most business owners started operations using their own savings, plus loans from family members and friends. Profits, however small, are plowed back into the companies for growth and expansion. When asked how they would go about funding a new line of business, owners indicated that they would most likely pursue these sources. There was a preference to pay interest on loans to friends rather than to the banks, but certainly the expectation was that

⁹ One focus group member indicated that he knew "hundreds" of people whom had been asked for a bribe as a part of a loan application.

¹⁰ While attachment of bank accounts by the tax authorities may not be as common as indicated by persons interviewed, the prospect of such occurrences creates widespread apprehension among members of the business community.

such lenders and investors were more likely to deal sympathetically with business problems and non-payment of loans.

Another answer to the hypothetical question of funding a new enterprise was “get a foreign investor”. Few of the businesses interviewed, or focus group participants, had a foreign investor, and few indicated any knowledge of how they might go about finding a foreign partner. This is not a likely financing source for SMEs. The constant citing of expected foreign investment reflects a basic lack of knowledge about how markets work and the competition with other investment opportunities.

It is hard to determine whether some of the notions about finance held by SMEs reflect unrealistic expectations, a lack of information, misinformation, or a combination of all three. For instance, some businesses indicated that they thought it would be reasonable to pay 2 – 4% per year for a bank loan. Businesses thought that there were loan programs available through some of the ministries, but did not know details. This suggests that an information campaign of sorts would be very useful.

It should be noted that there is virtually no supplier credit in the SME sector. World-wide, this is by far the largest source of credit for businesses of all sizes. One business did mention that it held some inventory on consignment but this appears to be the exception that proves the rule.

2.5 Other Perceived Constraints

Technology and Equipment - In all sectors, SMEs feel they need newer, higher quality equipment or technology in order to create a product consumers will want. Many firms have inherited or purchased old Soviet equipment, which is dated and in poor condition, but they have no means to finance the purchase of new equipment. Packaging and labeling equipment were often mentioned as needed but presently unattainable under current financing availability.

Limited Consumer Purchasing Power – Although the Georgian economy has improved recently, most citizens still do not have a great deal of income, and wages are low. A good number of participants in the seven focus groups and other interviewed firms cited the lack of sales demand, because of people’s low purchasing power, as a problem facing their business. Even though this is a larger macroeconomic issue, it still should be recognized as a constraint to private sector development.

High Operating Expenses – The cumulative amount of taxes, customs, and bribes may make operating costs prohibitive, particularly if the competition is able to lower its expenses by not paying taxes and/or selling cheaper smuggled goods.

Lack of Information - Some Georgian SMEs are aware of their lack of knowledge in certain areas and understand that this hinders their profitability. The most common areas mentioned where firms would like to have better information are: market information (both domestically and for exports), information on laws and government regulations, and available suppliers.

Loss of Traditional Markets – Many of the SMEs are now privatized and smaller versions of what they were under the Soviet regime. While once they had an assured market for their

production, mainly the former Soviet Union, this is no longer the case. These enterprises are now struggling to find new markets for their products. Moreover, there is little knowledge on how to create them.

Difficulty in, and Cost of, Procuring Raw Materials – Following the break-up of the Soviet Union, and the blocked routes through Abkhazia resulting from the civil war, supply channels for industry and trade were completely disrupted. Now, producers of goods often find that they must import raw materials from abroad. However, many enterprises claim that these raw materials are very expensive or difficult to obtain. For instance, a shoemaker in Kutaisi claimed that he had to import all his leather from either Turkey or Greece because the domestic materials were so poor, and in Zugdidi, a soft drink bottling company complained that it was no longer being able to obtain needed materials from the Ukraine.

2.6 Internal Management Problems and Limitations

Some of the internal problems experienced by Georgian firms have been described. It is fortunate when firms will acknowledge their limitations, because it suggests that they will be receptive to assistance to improve management skills. A greater problem, however, is that most firms seem to have little concept of how to operate in a market economy and have limited management skills. For instance, more than one non-operating firm that insisted that funding was all it needed to be operational clearly had done no investigation whatsoever about potential buyers. Worse, this inattention is frequently accompanied by an almost hostile attitude towards any non-financial assistance.¹¹

For example, the focus groups were asked about their competition and about advertising, and answers to this question were as revealing for what they did not say as the direct comments. Findings included the following:

- From a candy manufacturer – ‘we have no competition’. There is no other candy manufacturer in the region, but certainly there are lots of imports.
- A pharmacist did not consider a retail store selling the same over the counter medicine to be competition because the latter could not give pharmaceutical advice, yet complained that customers did not acknowledge this difference in expertise.
- Two small retail storeowners in the same focus group happily announced that they did not compete because ‘the goods (that they stock) and the prices are the same’. They indicated that having several stores selling similar goods in the same area was beneficial because collectively they attracted lots of shoppers.
- The businesses were most frequently competing on price, and complained bitterly about being undercut by “illegal goods”, i.e., smuggled goods on which customs duties had not been paid.
- Several of the businesses considered their competitive advantage to be higher quality goods or better service, yet were annoyed that customers did not seem to recognize this. When asked about advertising, however, the businesses expected that these factors were simply apparent, and there was no effort to communicate this.
- Advertising was often seen suspiciously, with an apparent underlying assumption that it included exaggerations or outright falsehoods.

¹¹ One speaker at an Imereti Chamber of Commerce and Industry conference seeking foreign investors, held in May, 1999, advised the audience that he was tired of training, and would the investors stop asking for business plans.

- There was little concept that advertising could be used to gain market share, or to differentiate the business. One retail storeowner indicated that he would rather spend scarce resources on improving the power generator than on advertising, because all the competitors' 'prices and goods are the same'.

The lack of market oriented thinking is ubiquitous. Marketing is constantly confused with selling, and the deeper strategic issues related to market development are generally little understood. The picture, however, is not totally bleak. Some business owners seem to be taking steps that would strengthen the businesses. There were examples of firms giving out samples, arranging displays that could be seen on a drive-by basis, offering time payments to customers (from a gasoline supplier), regularly advertising (household appliances, at the insistence of the Italian supplier), and one freight forwarding firm indicated that it had a web site. The business community in general will likely strengthen when other firms see these strategies succeeding in getting more sales and customers. There is a big opportunity here, clearly, to work with businesses to get them to break out of the fixed notion that price and quality are the only factors that can distinguish a business.

SECTION 3 FINANCIAL SECTOR CONSTRAINTS FOR SMES

3.1 Overview – Fundamental Problems in the Financial Sector

Commercial banks are typically the funding source for small and medium-sized business growth, financing fixed asset acquisition and working capital needs. Additionally, businesses rely on banks for other financial services such as current accounts. The banking sector in Georgia, however, an infant industry itself, is extremely fragile, and is not performing the intermediation function that is normally expected in a market economy.

Banks essentially operate by taking deposits from persons with excess cash (as well as providing safeguarding and payment services for those depositors), and re-lending the funds to businesses and individuals. If the bank has few deposits, it does not have funds that can be relent. The Georgian population has been reluctant to keep funds on deposit in banks for several reasons:

- Weakness of the banks. There is a very real risk of losing deposits through bank failures, and there are several examples of this both in Georgia and in the NIS region. In several of these countries, a great number of small, often self-serving banks were formed in the early 1990s. Through corruption, incompetence, or both, many of these failed on their own, or in times of economic crisis. Both bank regulation and internal management skills are being addressed, as described below.
- Rampant inflation. In 1993 Georgia experienced inflation rates of 7500% per annum, thus deposits (denominated in the national currency) in the banks essentially became worthless. At this point the macroeconomic situation has stabilized, although the recent Russian economic crisis did cause substantial fluctuations in the exchange rates. While macroeconomic conditions are not likely to be a critical problem to bank stability in the foreseeable future, concerns about the economic situation linger.
- Attaching and seizing of funds on deposit by the tax authorities. This factor has caused considerable distrust of banks, particularly among business owners. At this point it is necessary to get a court order to seize funds, but this seems relatively easy to obtain. More important, however, is merely the prevalent view that interference by the tax authorities is a common occurrence, and such rumors are hard to stop.
- Lack of liquidity in the banking system. This problem is its own cause and effect. Essentially, there is so little money in the banking system that the banks may refuse to pay out deposits for lack of actual currency.¹² If depositors cannot withdraw funds, they are not likely to make deposits in the first place.

All of these factors mean that there are very few deposits in the banking system and, realistically, it will be a long time before depositor confidence is established and the money in the economy is held in banks rather than in the mattress. The problem that this poses for SMEs is that if there are no deposits in banks, the banks do not have any funds to lend. If SMEs are unable to access credit, their growth is limited to the expansion that can be funded from other sources, such as savings, retained earnings, and loans from friends or family.

¹² A branch manager in Poti indicated that his bank and its chief competition in town did work with each other to ease liquidity problems. At present the National Bank of Georgia (the central bank) is constructing a regional facility in Poti, which should be able to assist in cash deliveries, but for the time being these two Poti branches cooperate in an informal fashion by providing cash to each other.

The problems of banking system development are, appropriately, receiving serious attention, and considerable work has been done at the regulatory and bank level to strengthen the banks. Most notably, the capital requirements (GEL 5 million minimum, about US\$2.5 million, which will be in effect by the end of 2000) are gradually being ratcheted up, which is causing the banks to merge or just go out of business. At present there are some forty-six banks in Georgia, down from a high of over two hundred, and within a few years knowledgeable observers expect that there will be some eight or ten survivors. Additionally, the central bank has instituted procedures to regularly do CAMEL (capital adequacy, asset quality, management assessment, earnings analysis, and liquidity assessment) analyses on the banks, and shortly will be training more bank examiners. Interestingly, the CAMEL ratings are made public, in part because there is no independent rating agency (such as Moody's) reviewing the Georgian banks, and in part because the banks themselves with high CAMEL ratings are using these to increase depositor confidence.

Assistance is also taking place at the bank level, and interventions include credit and asset/liability management advisors placed in the banks, and a banking and finance academy. Specific technical assistance and funding for lending is described at greater length in Sections 3.2 and 3.3.

3.2 Credit Availability

The Georgian banks are quite small by international standards. For example, the largest bank is United Georgian Bank, which has GEL 80 million, about \$40 million, in assets. The larger banks have offices in the major cities outside of Tbilisi (including Kutaisi, Poti, Batumi, Rustavi, Zestaphoni, and some others) but activity tends to be concentrated in Tbilisi. Credit approvals are centralized, through credit committees operating in Tbilisi.

There is limited credit available from the banks in Georgia, due to the lack of deposits to lend, as described above.¹³ Since virtually all of the deposits that the banks do hold are short term, loans are for short terms as well. International donors such as EBRD, IFC, and the World Bank have focused on the problem that SMEs do need credit and accordingly have given lines of credit to certain banks for on-lending. One advantage of the donor lines is that longer term loans, from 2 – 4 years, can be issued from these funds. These lines typically have limitations such as loan size or sector use, for instance, loans from IFC lines are not to exceed \$250,000, and World Bank funds are for loans for agricultural and food processing. These lines collectively appear to constitute as much as 50% of lendable funds.¹⁴ Loans are frequently denominated in dollars or other hard currency, because these lines and much of the deposits are denominated in hard currency as well. Correspondent foreign banks have also granted some lines.

While the banks are learning the rudiments of cash flow and credit analysis, they do rely heavily on client relationships (as one bank manager said, 'we only lend to clients we know') and on collateral. Loans to individuals are secured by possessory collateral of gold or gems

¹³ In the short run, the problem of the lack of deposits is being further aggravated by the withdrawal of deposits by international agencies. Previously, agencies such as the World Bank would keep project funds on deposit in local banks, and these monies were a significant percentage of deposits. With the Russian economic crisis and resulting bank failures there, however, agency policies have been revised, and only current operating funds are available locally, in Georgia and other NIS countries.

¹⁴ This should be regarded less as an indication of the amounts that the donors have loaned, and more of a reflection of the truly low level of money kept in the banking system.

(also called pawnshop loans). Business loans are secured with residences, firm-owned buildings, and equipment. There is no reliance on accounts receivable as collateral (however, few sales are on credit anyway), nor on inventory, although there are some instances of the banks warehousing inventory for collateral. (In other words, the bank effectively takes possession of inventory, and controls the flow of inventory in and out of the company by controlling the warehouse where the inventory is stored.) The banks require that inventory be valued by an approved independent appraiser, and seem to put a heavy reliance on that valuation. (It appears to be relatively easy to foreclose on real estate collateral.) Interest rates on the loans range from 24% to as high as 60% per annum.

The banks regard small and medium-sized Georgian businesses as risky, largely for the same reasons that have been noted earlier. Bankers cited high interest rates, corruption in government, lack of information, poor road systems, limited management skills, high tariff rates, and shortage of raw materials as typical problems facing the clients. There is a particular concern about the poor accounting and financial records, making performance and projection analysis very difficult.

The banks are taking some steps on their own to increase local deposits, including issuing debit cards and certificates of deposit, although they apparently do not charge penalties or reduce interest rates for early withdrawal. One bank indicated that it was interested in starting a microlending program of loans ranging from GEL 1,000 – 10,000 (about \$500 - \$5,000) with the specific intent of encouraging more deposits. (Most of the banks indicate that the smallest loan size that administratively interests them is about \$5,000, and it seems that cost structures would permit them to go down market more than this. There is also a microlending initiative among several banks, described in Section 4.) There seems to be some emerging competition for stronger medium-sized businesses, and the banks are strategizing relative to each other's markets. It is also important that several of the banks are raising salaries, such that the economic motivation for loan officers to solicit bribes should be reduced.

3.3 Donor Initiatives

In addition to the donor lines and top-down work with the banking system described above, several of the banks have EBRD and TACIS-funded advisors from European banks such as ABN-AMRO and Credit Commeciale de France, and from European consulting firms. These advisors are working in areas such as establishing credit policies and procedures, asset and liability management, and marketing.

One of the initiatives that likely will have the greatest impact are the hands-on lending programs being conducted by Shorebank Advisory Services (SAS). At present SAS is lending IFC and USAID funds through TBC Bank (though other banks are also eligible for these partnering programs), and is effectively transferring approval and monitoring procedures, approval forms, screening procedures, and financial analysis procedures. All loans are dollar denominated, thus the borrowers bear all exchange rate risk. The IFC funded program includes loans ranging from US\$10,000 - US\$250,000 (although the largest loan to date has been US\$130,000), for businesses that are typically two years old, generally have about US\$100,000 of fixed assets, and are production or service-oriented.

The Developing Enterprises Loan Program (DELP), funded by USAID, is for first time borrowers (although not start-up businesses) and includes loans ranging from US\$1,000 to

US\$12,000. (This is also referred to as a micro loan program, although the higher loan size and the relative sophistication of the businesses compared to the microenterprise market traders suggests that this is a misnomer.) This program was just started in Kutaisi, and does not operate in Tbilisi.

The real significance of the Shorebank programs is not the number of loans approved (28 IFC loans in twelve months with US\$720,000 currently outstanding, first approvals just coming now in the DELP program) but the specific demonstration effect of the programs. At present, there is still some practical negotiation going on in the DELP program¹⁵ but the SAS proven procedures should spawn several imitators. Also significant is the customer size, particularly of the DELP program. At present these customers are a bit below the size range being targeted by the banks, but are the typical, great majority of the SMEs in the country. Ultimately these businesses should be actively using the banking system, and the banking system seeking their business, for both sectors to have vigorous growth.

3.4 Findings

While development of the banking sector per se is beyond the scope of this assessment, it is so critical to the growth of small and medium-sized businesses that it cannot be ignored. In the long run, SMEs will be much better off to have a fully functioning, well regulated, transparent banking system. Credit is widely sought by SMEs, and there is a paucity of truly bankable deals, because businesses are so weak and are beset by other constraints. It is important for all recommendations concerning SME development to go hand in hand rather than counter to steps being taken to strengthen banking and financial institutions. Some of the recommendations suggested below would not be addressed by an SME initiative, but would help the development of the banking industry, thus indirectly would benefit SMEs.

- Continue the intensive assistance to the banking industry through the development of the supervisory and regulatory policies and procedures implemented by the central bank.
- There is no quick fix to the consumer confidence problem that is restricting the growth of deposits. Gradually, as bank capital requirements are increased and better supervision is in place, greater trust in the banks should emerge. It would be worth investigating instituting a deposit insurance scheme after the number of banks has been reduced further and the banking system is more stable. Such insurance could be targeted at a broad range of potential depositors, with coverage limited to, for instance, GEL 5,000 per account or per person. Initial funding for such a scheme might come from a major donor such as the World Bank or EBRD, with additions to the pool from premiums charged to the participating banks.
- Credit lines from donors have provided some needed loan funds for business, but there is a tendency for the banks to rely on these, and look for additional donor funding, rather than to develop a deposit base. Therefore, direct assistance to the banks, in the long run, is better in the form of advisory services that develop strong, customary banking services, rather than artificial funding sources. While funding for loans in Georgia is currently extremely dependent on donor lines, ultimately these lines pale in comparison to the

¹⁵ For instance, TBC Bank has the final approval of all loans since it is at risk for loan capital, but SAS may start sharing this funding risk so that TBC will take a less conservative posture.

amount of monies that should be intermediable in a functioning economy. To the extent that donor funding is provided in the short term, it is critical that the pricing on such lines not undercut development of true deposit funding.

- In the short run, SME development is hindered by a hard line attitude with respect to credit from the banks and donors. However, loans to SMEs generally are very risky at present, and both the banks and the SME sector are ill-served by a series of defaulted loans. For the time being, slower growth, funded by savings and retained earnings, is a preferable path to liberal and/or concessionary loan programs.

There is a need for more long term funding in the market, for acquisition of fixed assets by more established businesses. Initiatives for equity funding and leasing are discussed in Section 8, Recommendations.

SECTION 4 THE MICROENTERPRISE SECTOR

4.1 Overview

In the years following the collapse of the Soviet Union and, more recently, the civil war, a significant portion of Georgian citizens found themselves without the steady-paying jobs that many of them had held for years. Others, such as Internally-Displaced Persons (IDPs) from Abkhazia, also found themselves far away from their homes and with little opportunity for employment. Former teachers, workers in large factories, local government officials and those in many other types of jobs needed to find sources of income to support their families. Many began petty trading activities, such as selling clothing or food in urban bazaars, while others commenced productive sector activities, such as carpentry and food preparation.

A significant barrier to such individuals wishing to generate the income required to provide for their families has been the absence of credit from the formal financial sector. A growing number of microentrepreneurs, including IDPs, have had the opportunity to access credit through micro-finance programs operated by local and international NGOs. Such programs are intended to provide credit and related services to those who lack the required collateral and other means to secure financing to start micro or very small projects in trade, production or the service sectors.

4.2 Issues and Constraints

The expansion of microfinance institutions in Georgia and the growth and formalization of microenterprises are constrained by:

- **Lack of clarity in various laws which affect the general business community, including those relating to deposit taking and credit unions**
- **Lack of accurate and current information about tax rates and tax bases, and a complicated tax administration process which is perceived as corrupt**
- **Microentrepreneurs' lack of bookkeeping, accounting, marketing and business management skills**
- **Cumbersome business registration process**
- **Lack of information and perceptions of corruption associated with being formally registered as a business**

Some microfinance NGOs require clients participating in their programs to formally register their microenterprises. Some of these businesses, however, complain that there are at least five government offices they must visit to complete the registration process, and most of these offices expected some form of unrecorded fee. Bureaucratic and complicated procedures like this, and other obstacles listed above, lead many microentrepreneurs to choose to “stay below radar detection” by remaining very small and informal.

A key constraint facing microfinance institutions is that, under the existing banking law, they are prohibited from accepting any deposits that would be used as loan capital if they wish to remain exempt from central bank capital requirements for banks. For example, if a microfinance organization, whether NGO or otherwise, accepted such deposits, it would be considered a bank, and thus subject to the recently imposed central bank capital requirement,

which requires banks to reach a capital base of GEL 5 million by December 2000¹⁶. Since most microfinance institutions cannot meet such capital requirements, they choose to accept only deposits that are used as collateral or forced savings for clients. The institutions therefore rely mainly on grants from donors and other NGOs to fund their micro loan portfolios.

4.3 Sector Participants

The Assessment Team interviewed representatives of numerous local and international NGOs and donors¹⁷ that are actively engaged in microfinance activities. The general level of stability experienced in Georgia in recent years has prompted a number of humanitarian NGOs to expand beyond traditional humanitarian relief activities to economic development activities such as micro and small enterprise development programs. Several of the NGOs have had significant levels of success using group lending methodologies, where collateral takes the form of guarantees from members of a borrower group formed by several microentrepreneurs. The Team also observed several borrower groups in Tbilisi and Rustavi associated with Save the Children's Georgian partner organization, Constanta Foundation, and the Foundation for International Community Assistance (FINCA). These programs are described below.

Constanta Foundation

Constanta was founded in 1997 and began operations with a grant from UNHCR and Save the Children. Its group guarantee lending approach is drawn from Save the Children's successful experiences with this methodology in other countries. Constanta provides loans, at an interest rate of 4% per month, to groups of women for business purposes. Approximately 60% of their participants are IDPs. Borrower group sizes range from seven to fifteen women, each with at least six months of commercial experience. Constanta's program currently serves approximately 2,000 clients, nearly three-fourths of whom are engaged in trading or some form of resale activities. Most of the balance consists of individuals involved in preparing and selling food, while a small percentage consists of those involved in hairdressing, cosmetics and sewing.

Under the group lending methodology, each member of a "borrower group" will receive a subsequent loan only if every member of the group repays their current loan. Constanta's approach is very disciplined¹⁸ and consists of seven loan cycles (each is 16 weeks) reached by each group with new loans available only once the group has repaid the loan from the previous cycle. Loan sizes start at the lari equivalent of US\$100 per person and increase at each cycle by the lari equivalent of US\$50.

¹⁶ The capital requirement increases incrementally during 1999 and 2000, reaching GEL 5 million by December 2000.

¹⁷ Save the Children, Constanta Foundation, FINCA – Georgia, International Refugee Committee, CARE, International Orthodox Christian Charities, British Know-How Fund, IPC - Georgia, United Methodist Committee on Relief, United Nations Development Program and United Nations Office for the Coordination of Humanitarian Affairs.

¹⁸ Constanta takes a disciplined approach designed to ensure that new applicants understand the risks and responsibilities associated with borrowing money. Each member of a borrower group is given an application and a copy of the program's by-laws, followed by verification by Constanta of the identity of each group member (to minimize the chance of fraud). A Constanta loan officer explains each line of the application and outlines the responsibility of the group and its members. To ensure they understand the program and their responsibilities, each member is then tested by the loan officer about the program.

Constanta currently operates its program out of its Tbilisi office but has plans to expand to Kutaisi and Batumi, once it is able to secure grant funding. An application with USAID's Microenterprise Implementation Grant Program, for this purpose, is pending. Constanta emphasized that it seeks markets with a large IDP population because the women in these areas are very poor and dramatically under-served by the financial sector.

Foundation for International Community Assistance - Georgia

Foundation for International Community Assistance (FINCA) Georgia has been operating a microfinance program in Georgia since July 1998, following the awarding of a US\$15 million grant by USAID to Shorebank Advisory Services and FINCA for the development of a Caucasus SME finance program covering Georgia, Armenia and Azerbaijan. The FINCA program is funded out of a US\$9 million pool of funds allocated to FINCA from this grant for use in all three countries. In Georgia, FINCA decided to deviate from its standard village banking model to the group guarantee model that has been so successful for Constanta and others.

FINCA reports it now has over 6,000 clients. Nearly 95 percent of FINCA's clients work in urban bazaars in Tbilisi or Rustavi and are involved in petty trade activities. FINCA borrower groups average 11 people and are open to men and women. FINCA offers loans in 16-week cycles, with the maximum of cycles to be determined¹⁹ once the program has been operating longer. Loan size starts at the Lari equivalent of US\$100 and increases each cycle. The interest rate charged is five percent per month and there is a savings requirement of 10 to 30 percent of the amount of the loan received, depending on the credit rating of the client. Start-up enterprises are avoided because of the additional risk involved, as are agricultural loans because of the longer terms required for such loans.

FINCA is currently operating out of its Tbilisi office, although it uses a small market office in Rustavi for borrower group meetings. FINCA is looking to expand to bazaars in Kutaisi and surrounding towns, as well as to Gori. Its strategy is to find a hub city, from which loan officers can serve clients located in bazaars in that city, as well as those in surrounding towns.

International Rescue Committee

While the International Rescue Committee (IRC) is primarily a humanitarian organization focused on refugee issues for several years, it has been engaged in microfinance activities in Georgia since 1997. IRC focuses its microfinance efforts on the IDP population in and around Kutaisi and Zugdidi. Loans are made to both individuals and groups of borrowers, with loan sizes ranging from GEL 150 to GEL 1,000 for group loans and GEL 500 to GEL 5,000 for loans to individuals. IRC requires one week of training for all individual loan applicants to prepare a business plan that is submitted to IRC before they receive credit. IRC has received funding for its microfinance activities from United Nations High Commission for Refugees and Stichting Vluchteling, and more recently received a grant from USAID to establish vocational training centers and business incubators in Kutaisi and Zugdidi.

¹⁹ FINCA's village banking programs in other countries normally have a maximum of nine cycles.

Microfinance Bank of Georgia

Most commercial banks in Georgia, as elsewhere in the world, do not engage in direct microfinance lending activities, mainly because of the relatively high costs and risks associated with such lending. While one bank in Georgia indicated an interest in establishing a microfinance loan program, most banks have acknowledged that they would prefer to share the risks and administration of such programs with others. In 1998, the German development bank, Kreditanstalt fuer Wiederaufbau (KfW), conducted some market research on the demand for microfinance services in Georgia. Based upon this research, discussions were held with various donors, international NGOs and Georgian commercial banks concerning the creation of a bank that would focus exclusively on the micro and small enterprise sectors. Following the successful completion of these discussions and subsequent negotiations, such a bank, Microfinance Bank of Georgia (MFBG), was created in late 1998 with the following shareholders:

KfW (German development bank)	35%
International Finance Corporation	20%
FMO (Netherlands Development Finance Company)	10%
IMI (German microfinance bank)	10%
Georgian commercial banks ²⁰	25%

Initial loan capital will be drawn from a low interest credit line from KfW. MFBG was expected to open in October 1998 but several start-up issues, including the bank licensing procedure, have delayed the opening to the middle of May 1999. The bank will be managed by IPC (Internationale Projekt Consult GmbH, a German development firm) and will introduce IPC methodology its has used in IPC programs in Russia, Ukraine, Kazakhstan and other parts of the world.

MFBG will offer loans ranging in size from US\$1,000 to US\$50,000. Terms will range from 8 to 18 months for working capital loans and up to 24 months for fixed asset loans or working capital loans for production purposes. When the bank feels the Georgian environment is ready, it could increase the term of loans to as long as five years.

The demand for the loan products offered by MFBG is expected to be large, but clients will likely be those in the small and medium category rather than the traditional microenterprise category. Initial estimates of loans in the pipeline average over near US\$20,000 per loan. The bank's indication that it is prepared to increase loan size to as high as US\$500,000, once it becomes more comfortable with the local market, is a clear indication that it is aiming far above anything resembling the microenterprise sector. MFBG indicated that it expects to attract a significant portion of the banking market in Georgia.

One proposed service of MFBG that is indeed within the microfinance range is pawn loans. These are loans between US\$50 and US\$1,000 designed for entrepreneurs working in markets. Unlike the group lending methodology employed by other microfinance institutions in Georgia, the only acceptable for of collateral for these loans

²⁰ TBC Bank, TbilComBank, IntellectBank and TbilCreditBank

will be gold jewelry or diamonds. Terms will be up to six months and the interest rate will be between four percent and five percent per month.

Other Microfinance Programs

International Orthodox Christian Charities (IOCC):

- Humanitarian charity arm of US/Canadian Orthodox Catholic Church.
- Works in the Samtskhe-Javakheti region of Georgia.
- Moving into some development activities, including credit.
- Recently set up loan fund (using monetized cooking oil from USDA Government) for SMEs, making loans to productive sector (farming, small manufacturing, honey production, services, etc.) at 15% interest rate for terms up to one year.
- Loan sizes will range from lari equivalent of US\$500 to US\$1,500, reflecting its choice to focus on clients closer to the small, rather than the traditional micro, category.

United Methodist Committee on Relief (UMCOR):

- Working on humanitarian relief, health and agriculture related programs in Georgia since 1993.
- Supports farmer credit cooperative development in Bolnisi, including the provision of US\$50,000 in capital, in cooperation with ACDI/VOCA's Enki Foundation and in parallel with their seed program. Loan sizes available through the cooperatives can reach as high as lari equivalent of US\$10,000.
- Established seven agricultural credit associations that make loans ranging in size from lari equivalent of US\$300 to US\$800.

4.4 Findings

The microfinance activities at FINCA and Constanta have been successful in generating income for several thousand individuals. The methodology seems appropriate for the current activities of these NGOs and a firm foundation for their planned expansion to cities and towns in regions outside Tbilisi.

Recent support to IRC in the area of vocational training centers and business incubators is expected to deal with skill development of small business owners. Services offered will include: accounting; business support; marketing assistance and related technical assistance.

Lessons can also be learned from newer programs managed by UMCOR, IOCC and other new entrants to the micro and small enterprise finance arena. The UMCOR is building on its strong experience in the agricultural sector and its agricultural clients should benefit from UMCOR's partnership with ACDI/VOCA, a leading NGO in agricultural development. The IOCC loan program has not, as of mid May, 1999, disbursed its first small business loans. It is working in an under-served region of Georgia and its experiences should be monitored closely.

SECTION 5 BUSINESS SUPPORT ORGANIZATIONS AND ASSOCIATIONS

5.1 Demand for Business Services

Recent thinking on SME development has emphasized the need to promote and develop strong local business support organizations and associations, both as providers of relevant services such as management advisory and training services, as well as broad-based vehicles for policy dialogue and lobbying efforts with government.²¹ Conventional wisdom suggests that building local capacity in this arena is likely to produce long term positive impact at three fundamental levels: the firm, supporting institutions and the policy environment within which the other two operate. Developing the supply of these services has become a centerpiece of many SME strategies in other NIS countries.

Several of the findings gleaned from our investigation appear to challenge this standard approach for Georgia, at least for the time being. Our interviews with SMEs brought to the surface how little effective demand there is for traditional types of business training and advisory services. Most managers interviewed clearly stated that they did not need management assistance running their firm. Almost as if on cue, they would state that all they need is money or a foreign investor and the enterprise would be successful. However, the fact is that these managers have a serious lack of business management skills and minimal understanding of how a market economy works. Certainly the need exists, but our findings indicate that most entrepreneurs see little value in the non-financial services being offered at this time.

During interviews, many entrepreneurs expressed disillusionment with the idea of business plans. To acquire credit or attract investors, enterprises have been told repeatedly that they must have a business plan. In this context, business plans have become merely a formality that donor projects have pushed and financial institutions require. Many SME managers see business support centers as places where you go to get the required business plan for a loan. One pays a fee and the business advisor produces the formal document, which may not even be read by the business client. Most SME managers have little understanding of how a plan can be used as a strategic tool to help them manage or position their company in the market.

Nearly all of the business consultants interviewed in Georgia recognize these deficiencies. While they understand the real need for developing business skills among SME managers, they have been, for the most part, unsuccessful in convincing them of the value. The impression one gets from talking to managers of businesses is that training has been too academic, without real-life applications. A course on “Marketing” or “Financial Management”, for example, seems abstract and useless to the average Georgian manager if they can’t apply it immediately to a pressing problem. Unless they can see actual results, firms are hesitant to pay for management assistance and/or training or even attend free courses.

Similar views were evoked during discussions regarding business associations and chambers of commerce. In the seven focus groups conducted, few participants were members of associations and the few who belonged to associations saw little value in membership. Our interviews with firms revealed much the same: most SME managers do not see the need for

²¹ See page 3: USAID SME Development: Strategy for the Caucasus Region, March 1998 by Management Systems International

such organizations. These opinions all point to a general lack of demand from the business community for business associations that do not deliver tangible benefits to members.

While few saw the value in official chambers and associations, everyone participating in the small group discussions enthusiastically enjoyed the opportunity to discuss issues and share experiences. Many agreed that it was a good idea to get together, even though they are skeptical of “official” gatherings, which often become vehicles for ambitious individuals to pursue their own political agendas.

5.2 Business Support Organizations

Providers of Firm level Assistance

Several noteworthy efforts have been made over the past several years to augment the supply of quality business advisory services to SMEs by establishing business services centers. Perhaps the most well-known examples are the Small and Medium Enterprise Development Agency (SMEDA) in Tbilisi and Business Support Center (BSC) in Kutaisi, both of which were developed under EU-TACIS funding supported by European technical assistance. Under the initial project, both centers provided a range of business management training and consulting services to firms on a fee basis, albeit at highly subsidized rates. Consulting services provided by these TACIS centers have been mainly devoted to producing business plans for clients wishing to receive a loan from a bank.

Recently, both of these centers have been transformed into private companies in an attempt to sustain the services developed under the project on a commercial basis. While these centers appear to be staffed with well-trained professionals, both new companies are having serious problems surviving in the market. The difficulty of obtaining loans from banks has undermined the demand for business plans. As noted above, business people are generally unwilling to pay fees before results are achieved, especially at fully-loaded rates. According to BSC, some clients are willing to pay a fee based on a percentage of the increased revenues typically 1-3% of sales. But such payments often take time to realize, frequently resulting in cash-flow problems for the service provider.

In both of these centers, training courses have not covered their costs. For the most part, training courses have been dropped from the product offerings unless donor support can be found. Both companies are now developing new services for potential foreign investors and larger companies. The transition from a project to an independent company is difficult under any circumstances. It is too early to tell if either organization will survive beyond 1999 as a commercial entity.

Building commercial viable business services centers for SMEs appears, at this time, to be unrealistic. If business service centers are to survive as independent companies they must move away from providing services to smaller businesses and develop innovative products and services for new customers able to pay higher fees. The most lucrative market for SMEDA and BSC are foreign investors and/or donor organizations, not Georgian SMEs.

It is difficult to form a definite opinion about the quality of services provided by the TACIS-supported consulting centers. Anecdotal information gathered from clients suggests that some of the services are too academic to be useful. One company had to redo a market study to make it reflect the “real” situation in Georgia because the consultants had only prepared a

desk study lacking field analysis. Others appear to be satisfied with the services. A Kutaisi-based building materials manufacturer expressed sincere appreciation for the services it received from BSC. In this case, consultants were able to successfully develop a market relationship between his company and a German buyer.

The Team has some reservations about the partial ownership of both SMEDA and BSC by the chamber of commerce and local government. Eighty percent of the SMEDA shares are in the hands of the Georgian Chamber of Commerce and Industry, the “official” chamber of commerce in Georgia. In the case of BSC, the chamber owns 25% percent of the shares and local government owns an additional 25%. The leadership of both SMEDA and BSC see this close relationship with government and other official organizations as a positive way to get things done in the Georgian environment. Due to this affiliation, however, at least one international NGO took the decision not to work with one of the centers. Several entrepreneurs also expressed concern that client work may not be kept confidential on tax matters. Though there are no indications of improper actions, it does illustrate the problem of “image” if the centers are too closely tied with quasi-government organizations.

In the agricultural sector, TACIS has set up two agro-business consultancy centers (ABC centers) in Gori and Tsnori. In June, 1999, two additional centers will be opened in Ozurgeti and Kutaisi. The Kutaisi center will be staffed with already trained BSC employees. Before consultants can work at the ABC centers, they must undergo training for 6 months in management, farm and business planning, and preparation of loan applications for banks. At the end of the training the best 4 out of 10 consultants are hired for a particular center. The services offered are similar to SMEDA or BSC during the period of project assistance but geared more towards agribusiness.

Like SMEDA and BSC, the ABC centers will be converted into private companies within the next few years. As in the case of the other TACIS centers, sustainability will depend upon moving beyond the traditional services of training and business planning. Though training and business planning are still offered, in anticipation for the impending move towards a private company, the ABC center in Gori is diversifying its service offerings. They are currently expanding into artificial insemination for pigs, seed trials for vegetables and other types of support services to agribusiness farms which farmers will pay for. Again, the best alternative for achieving sustainability appears to be selling services to potential foreign investors or becoming local agents for the proposed Agribusiness Bank, which is now being formed out of another TACIS project. A close link with this financial institution will definitely increase chances for the four centers to make a successful transition to viable private companies.

One of the unique suppliers of business services in Georgia is the Center for Enterprise Restructuring and Management Assistance (CERMA). CERMA is a World Bank-TACIS project set up to render post-privatization assistance to enterprises. It functions as a non-profit, non-governmental organization with the objective to manage, monitor, and coordinate the international technical assistance rendered to support enterprises restructuring throughout Georgia. Their clients are large and medium enterprises. CERMA is currently working intensively with 15 companies with a goal of turning around 50 in the next few years. About 200 Georgian consultants and managers will be trained under the project. The vision of CERMA’s leadership is to build a private company or non-profit foundation out of the project. The firm might eventually comprise about 10 to 20 of its top consultants.

CERMA adopts a hands-on approach to management assistance. Before an enterprise is selected for assistance, the owners must sign a contract with CERMA agreeing to specific terms and conditions, the first being upgrading the accounting system to international standards. Once a contract is signed, the client is assigned to an expatriate turnaround expert working with several Georgian professionals. CERMA, in effect, assumes major influence over the company's management, if not *de facto* decision-making authority. Georgian consultants and client managers are both mentored by the expatriate advisor. The process is a dual one: turnaround assistance to companies and intensive training for Georgian managers in running companies in a market-oriented way. Georgian managers are also sent for training in similar companies in nearby countries (Greece, Turkey, and Italy) sometimes for as much as several months.²²

Better management and market development are the primary tools CERMA uses in turning around client firms. Necessary financing is usually secured by bringing in a foreign investor. This has been demonstrated as the most practical way for the company to obtain new technology and for CERMA to exit from the consulting relationship. CERMA's experience illustrates that effective firm level assistance in the Georgian context must be "deep" and sustained enough to re-orient the strategic direction of a company. In this manner, CERMA's approach contrasts sharply with the more typical "arms length" advisory and training services provided by most business centers. The basic issue that remains is cost-effectiveness of the CERMA approach.

In addition to business centers and CERMA, there are a number of international non-governmental organizations that provide business services to firms. In small business support, CARE assumed an early leadership role by launching a pilot program in the Imereti region in 1996 when most other NGOs were still working in relief and humanitarian aid. CARE's lessons in this area are instructive. Based on initial experience, CARE found that existing Georgian service providers were often too academic and out of touch with what the small business market wanted. To rectify this, CARE's pursued a strategy of first becoming a direct service provider to clients and working to build demand for services. Gradually CARE's program moved towards building local institutions once the supply of services were better matched to rising demand and local partners had been identified and selected. It also linked business services with financing. As indicated above, non-financial services alone appear not to be valued by Georgian businesspersons. Unfortunately, the unexpected collapse of the bank through which CARE was operating its credit guarantee scheme set back the entire effort. Nevertheless, CARE's experience in delivering non-financial services to small business is noteworthy, their approach is sound.

Another major player in providing services to firms is the International Executive Service Corps (IESC). Supported by USAID, IESC has assisted more than 100 companies and business support organizations in 12 cities throughout Georgia. The main form of assistance is American business volunteers, usually retired, who provide direct technical assistance to individual firms. The volunteers work closely with the firm for several months initially. IESC has provided volunteers to a wide variety of companies including food processing industries, various service businesses, and light industry such as garments and textiles, among others. Firms provide in-kind contributions worth about US\$80 per day. Although the main

²² The Executive Director of CERMA likes to speak of the program as the most effective business school in Georgia.

focus is on firm level assistance, IESC has also worked with local business support organizations and associations including the Georgian Association of Innovative Technologies, the Georgian Accountants Association, the Geothermal Association of Georgia, and the Georgia “Women In Business” Association.

Most firms interviewed have found this kind of management assistance very useful, and many volunteers regularly keep in touch with the Georgian companies and try to assist them from the U.S. after the assignment is over. Based on interviews with several IESC clients, the team suspects that some of the management, marketing and technical problems faced by clients are so profound that short-term assignments can only scratch the surface. Longer-term consulting relationships and follow-up visits should be encouraged whenever possible.

Management consulting capacity outside of donor supported projects is limited to a few small firms and self-employed individuals. The exception that proves the rule is Georgia Consulting Group, an example of a fast growing private sector-consulting firm. GCG provides services in legal, accounting and management consulting services. Having started in 1992, they now employ 45 consultants in management consulting services alone. The primary clients of GCG are foreign companies. It is likely that the firm will soon link up with one of the big five international accounting firms as a local partner.

Educational Institutions

The amount of business school training that is available in Georgia is limited. There are two programs or initiatives that are of particular interest in terms of development of western-style management disciplines: European School of Management (ESM) and a new program now being set up in conjunction with the US Georgia State University.

ESM has been developed through the Tbilisi Business School (TBS), and offers a four-year, undergraduate business administration program. TBS itself conducts postgraduate programs, as well as specific training courses for non-degreed employees of companies. It reports that the highest course demand is in accounting, followed by marketing and financial management, and that some 92% of its graduates are immediately employed, at salaries higher than those realized by the graduates of state universities. ESM has had regular cooperation agreements with Bryant College in the US, the London Business School, ESM International in Spain, and the Berus Academy in Germany, as well as occasional work with the University of California/Davis and other schools. It is continuing to seek liaisons with other schools, specifically looking for books and opportunities for training of trainers. In 1996 ESM did do business course presentations for CARE in connection with its loan program in Kutaisi.

A new business school program which would partner (the US) Georgia State University with several of the Georgia universities is being developed under the auspices of Eurasia Foundation and the United States Information Service (USIS). Eventually this would lead to

the establishment of a full MBA program, with degrees awarded by Georgia State.²³ This program is just in the formation stage.

Government programs

The Parliament is currently considering a “Law of Georgia on Support of Small Enterprises” which would establish a “Center for Development and Support of Small Enterprises.” This center supposedly would provide information and consulting to small businesses and also distribute financial assistance. However, many entrepreneurs in the private sector and in the donor community as well are extremely wary of any government created “center” for small business.

Another government initiative is the Small Business Development Fund. This is a loan fund that was established by the Government of Georgia, with some technical assistance from the Netherlands. While GEL 7 million has been nominally allocated for the program, to date GEL 1,457,000 has been loaned through Tbilcom Bank to 27 businesses in the past two years, including twelve in Tbilisi and fifteen in the regions, and funding divided in approximately the same proportions. This program is targeted at job creation, and loan terms are for two years.

5.3 Chambers of Commerce and Associations

Business associations in Georgia can be broadly classified into three types: 1) quasi official chambers; 2) voluntary business associations, and 3) professional associations and special interest groups, for the most part are tangentially related to business issues.

Georgian Chamber of Commerce and Industry

Representing the first category is the Georgian Chamber of Commerce and Industry (GCCI). It is the primary association for Georgian businesses and the kind of model of what business associations are in the minds of most Georgians. The organization has its roots in the former USSR Chamber created in the 1950s to facilitate trade between republics, keep records, facilitate trade and industry delegations and represent them at official functions. After independence, the chamber leadership undertook a study of how chambers worked in free-market economies. They studied the Anglo-American model based on private voluntary association and the Central European model, based on public law. Unlike most former Soviet republics, which adopted the voluntary model, Georgians opted for the mandatory model of Germany and other central European countries.

In 1995, the President issued a decree that the chamber of commerce would be organized under public law and membership was mandatory for all registered businesses in Georgia. This decree has never been strictly enforced. A piece of legislation is now before the Parliament, which would change this administrative decree into a formal law. It is unlikely to pass this session, but it appears to have strong political support from government and some European donors. USAID has been a strong opponent of this bill since it contradicts fundamental voluntary principles²⁴.

²³ The Tbilisi Business School was originally a part of this consortium but pulled out, since it feels that its students are higher caliber than the students of the other schools in the group.

²⁴ It is revealing that the Team found no support for mandatory membership in the focus groups. To the contrary, many felt mandatory membership was just another tax for services not rendered.

The chamber leadership strongly supports the bill. GCCI firmly believes that mandatory membership will serve the interests of smaller firms. Without mandatory membership, GCCI believes only the larger companies will be willing or able to pay dues in voluntary associations. Associations, according to this view, would end up serving a narrower spectrum of interests. The issues of the public law versus private voluntary association are unlikely to be resolved any time soon but the Team encourages the adoption of the voluntary model as a part of GCCI's own market-oriented transformation.

The GCCI is headquartered in Tbilisi with a network of nine regional chambers. Regional chambers have considerable autonomy to elect the governing Board, establish budgets and decide on expenditures. Each region, however, is expected to remit 30% of its revenue to the central office. Membership fees are GEL 40 per year and paid only to regional chambers. The central coordinating office in Tbilisi has no members by itself but receives its operating budget from the remittance. The headquarters provides a central coordinating function and expects to play a major role in lobbying efforts.

GCCI has about 5,000 members. It offers members various services including information, certificates of origin, seminars on taxation, business registration, business planning, legal consultation, and an arbitration court to resolve conflicts between businesses. They have 28 staff working at the headquarters and all the above services are free, being paid for out of membership dues and some donor support. As mentioned above, GCCI owns 80% of SMEDA, one of the best known providers of business services in Georgia. If SMEDA is having trouble surviving on a commercial basis, there is no intention by GCCI leadership, at the present time, to subsidize the operations out of membership dues.

The team visited two regional chambers in GCCI's network. The Imereti Chamber of Commerce and Industry, (ICCI) located in Kutaisi. The ICCI has 890 members. All companies in the Imereti district are strongly urged to join the chamber and are obliged to pay the GEL 40 annual fee. For this fee, they receive most of the same services offered by GCCI in Tbilisi. The team also met with the Poti Chamber of Commerce and Industry. It has 270 members and functions along similar lines.

As mentioned above, most businesspersons are aware of the chamber in their region, but they generally do not regard it as useful to their business. Those who belong often do not see the benefits of belonging. Most chamber leaders we talked to are aware of the poor reputation, but consider the problem to be a lack of public understanding rather than poor quality services. To be fair, GCCI leadership appears to be trying to adapt to the changing times and become a respected European type chamber under public law. There seems little chance at this time that GCCI can be persuaded to adopt a strategy of becoming a voluntary association under private law. While this runs counter to what the Team would recommend as the best option, there may be room for current and future private voluntary business associations to collaborate with GCCI on selected policy reform issues of common concern.

Voluntary business associations

In recent years several voluntary associations have emerged largely supported by foreign companies and prominent Georgian businesspersons. The first is the International Chamber of Commerce and the second is the newly formed American Chamber of Commerce. Both of these chambers represent the interests of large foreign companies, smaller-scale foreign

investors, joint venture companies and market-oriented reformers. They came into formation as vehicles for putting pressure on government to improve the business climate. While they are welcome entrants into the process of dialogue most Georgian business people outside of Tbilisi are not even aware of their existence. They seem to serve somewhat narrow interests, although most of the issues they address have wide relevance for the entire business community.

International Chamber of Commerce (ICC) was formed two years ago and has 110 members. The fees for the chamber are \$60 per month, very expensive for smaller businesses. The main focus of the chamber is to lobby the government and advance reforms to make the operating environment more hospitable for foreign owned businesses. For instance, the chamber is recommending that the Georgian government lower the tax rates for foreign-owned companies so that the country can attract more investors (similar to what Ireland has done). ICC is more associated with European companies although, in terms of dollar value, American companies contribute more to the organization's revenue.

The American Chamber of Commerce (AmCham), formed only months ago, currently has about 30 members, made up of companies and organizations with strong links to the United States. AmCham appears to be very active. Members meet regularly for lunch meetings and pursue lobbying efforts to address such issues as tax reform, corruption, and bureaucratic harassment. USAID is also represented in this group.

These two chambers represent positive forces for change on the Georgian landscape. Currently, however, their image is too identified with foreign interests to serve as effective vehicles for broad-based chamber development. Unless an attempt is made to broaden the base of membership in the regions outside of Tbilisi and re-formulate their strategic intent, these two chambers will likely stay relatively small using their considerable influence to reach key government officials and change things from the "inside". If nothing else they will serve the Georgian business community as models of how voluntary associations can function. If they were to choose a broader based strategy, they might evolve into something quite powerful indeed.

One of the problems faced by voluntary business associations at this time is how to become effective lobbyist without developing into a political party. The recent rise of the Entrepreneurs Union is an excellent example of how the formation of business associations can quickly turn into political parties in the Georgian context. Another example is the increasingly vocal Taxpayers Union. They have groups in many areas around the country focussed on the issue of tax reform and corruption. Once the tax issue is mitigated to some extent, there is a possibility that the union might form the nucleus of a new broad-based business association. On the other hand, it may become another political party or dissolve from lack of support. It is too early to foresee the outcome.

Professional Associations

There are a growing number of organized professional associations in Tbilisi. The ones that truly deal with business issues are the Georgian Federation of Professional Accountants and Auditors, the Landowners Rights Protection Association, the Young Economists' Association and the Young Lawyers Association. Most of these associations offer training to their members and also provide advocacy services to lobby the government on pertinent issues

affecting business. The professional associations are more developed in Georgia than typical business associations.

USAID is assisting the development of a real estate self-regulatory organization (SRO), called the Association of Real Estate Participants, under its land reform program. This organization will be made up of real estate professionals and will represent their interests. The organization will be one of the first self-regulating professional organizations in Georgia ensuring that members comply with existing real estate-related laws and adhere to professional standards.

5.4 Capacity Building Efforts

One of the key organizations involved in wide ranging capacity building efforts for associations, NGOs and business support organization is the Eurasia Foundation. The Eurasia Foundation has awarded a number of grants that directly support the growth and development of small business. Grants have supported such initiatives as training and counseling for entrepreneurs, information dissemination on business topics, development of specific business sectors and legal and policy reforms aimed at improving the environment for private business. The foundation also supports general management skills training, economics education and the development of local business associations and NGOs interested in policy issues.

Eurasia's methodology is practical and innovative. Instead of giving grants to merely assist an organization with its operational costs, they help fund specific products or services that will strengthen the organization and make it more useful to its constituency. They support a wide variety of programs, which appear to be having an important impact on the development of a "new mentality" and a dynamic Georgian NGO sector. Some feel the organization may be too diffuse in its grant giving and greater impact could be achieved through greater focus. Most, however, are supportive of the program and its efforts to seed new forces for change.

5.5 Findings

This overview of the supply and demand for non-financial business services illustrates how diverse both the organizations and services can be. After interviewing the providers of business services and the firms that are targeted, the main findings are as follows:

- SME owners and managers have few of the business skills needed to succeed in the market economy. There is almost no concept of marketing, which is often confused with the selling function. The deeper strategic issues related to market development are little understood. Managers are still focused almost entirely on production. There is little if any service orientation or product design to satisfy the wishes of a customer. Furthermore, financial management and accounting skills are very poor.
- While this lack of skills is very evident, there is little awareness of this by the enterprise managers themselves. They generally believe they are competent in business management – their only problem is lack of financing. Because of this lack of recognition, the market for training or any other business assistance is limited. There is a serious need for services, but no desire to receive, much less pay for them.

- Business associations and chambers of commerce are perceived as rather useless, quasi-political organizations that provide few services that the average entrepreneur values. Businesspeople enjoy the opportunity to discuss issues, but they want the setting to be informal and private so those real problems can be addressed without political jockeying for power.
- In contrast to business associations, professional associations appear to be less political and better organized around the needs of their members.

Conventional approaches to SME development in other NIS countries are premature in the present context of Georgia. Building sustainable business service providers and broad-based member-driven associations into an effective lobbying force appear unrealistic until demand for them increases and local initiatives emerge which can then be supported. In the meantime, direct interventions may be required to start-up and re-orient SMEs towards market-driven approaches bringing together financing, management and marketing services to companies likely to grow quickly and create new jobs.

SECTION 6 POLICY AND REGULATORY FRAMEWORK

6.1 Current Issues and Policy Reform Efforts

Numerous policy reform efforts have been completed or are presently underway in Georgia that will affect SMEs. Much of the dialogue supporting this effort is donor driven and has taken a multi-channeled approach, whereby donors coordinate on issues but lobby the Government of Georgia separately through key contacts each has identified. Donors have taken this approach because the business associations and chambers of commerce are not yet at the point in their development where they can be the most effective vehicles to lead policy reform efforts.

Corruption

This issue is raised in nearly every conversation with business people, NGOs, banks, business support organizations and others. Most interviewees said that corruption is everywhere, at nearly every level, and that it has been around for as long as people can remember. Many indicate that the systemic levels of corruption in Georgia are vestiges from the Soviet era. The extremely low salaries paid to police officers, tax inspectors and others in positions of authority makes it somewhat understandable why they so often seek bribes and other payments.

Many of the young, progressive members of Parliament, supported by emerging citizen political advocacy organizations, are taking positive steps to reduce corruption by, for example, calling for the elimination of potential conflicts of interest on the part of government officials at various levels. These and other reforms are endorsed and supported by citizen associations, donors and others interested in attempting to reduce the prevalence of corruption in Georgian society but, due to the systemic levels of corruption, will take a significant amount of time to remedy.

Tax and Customs Reform

Many businesses interviewed indicated that the large number of taxes²⁵ to which they are subject, combined with aggressive collection methods of the Tax Department, forces them to under-report their earnings in order to have sufficient funds to stay in business. Most SMEs, especially those located outside Tbilisi do not have anything close to the latest information or guidance relating to taxes.

²⁵ **VAT.** The taxable operations (delivery of goods, services by a person on the territory of Georgia) and taxable imports (import of goods except of those exempted from paying VAT) shall be subject to VAT, comprising 20% of the value of goods and services. It is paid at every stage of operation and import.

Profit Tax. For Georgian companies as well as for the foreign companies with permanent establishment in Georgia the rate of the profit tax is determined in the value of 20% and the withholding tax for dividends, interests and management fees is 10%.

Excise Tax. New tax on cigarettes and alcohol.

Tax on Property of Enterprises(TPE). The rate of TPE is determined to 1% of the value of the company's property calculated on average value.

Personal Income Tax (PIT). The taxable gross income of physical persons includes incomes received in a form of salaries. Technically, the PIT is paid to the budget by the employers of individuals, through a deduction from the incomes of their employees.

Social Payments (health protection fund and social security contribution) are deducted, along with deduction of PIT, from the salaries of the employees.

“There is a sea of literature in Tbilisi, but you need a professional who will direct you where to go. Also, we receive new laws every day but before it reaches us here [in Batumi] it is already old.” -- Small business group, Batumi

The Georgian Government introduced a new tax code in September 1997 but there have been several criticisms of the code:

- The tax code was drafted in English and the subsequent translation to Georgian is said to contain many mistakes that confuse the issues.
- The code contains many ambiguities, further complicating the tax calculation process, leaving many SMEs clueless as to the amount of tax they owe, and leaving them vulnerable to tax collectors’ aggressive and unorthodox collection methodology. These collectors are known to mislead or intimidate businesses intentionally (designed to generate an adequate bribe for the collector) or unintentionally (most collectors have little knowledge of accounting or how to accurately calculate the tax).
- Few copies of the tax code seem to be available outside of Tbilisi, compounding the problem for SMEs and others in regional towns and rural areas.

The Tax Department has the authority to examine all financial documents, accounting books, reports, cash flows, securities and other documents related to the calculation and payment of taxes.

The US Treasury has placed a senior tax advisor, from the Internal Revenue Service, in the Tax Department to assist in reforming the department’s organization and procedures. A key improvement will be to train tax inspectors in the new international accounting standards (in coordination with USAID’s GEAR project, described below) and prudent, transparent tax administration procedures. Six different manuals have been prepared which cover: examination standards; examination management philosophy; examining revenues; examining expenses; corporate examinations; and indirect methods. Working with senior department officials, attempts are being made to reduce the number of staff who have direct contact with the public and reduce their authority to collect taxes. USAID is supporting efforts to reexamine tax laws, such as those relating to the Value Added Tax (VAT).

Conversations with any business which imports supplies or goods, or uses such goods, will reveal their frustration at the high customs duties and the level of corruption associated with cross border shipment of goods. This is a large added cost of doing business for SMEs. As stated earlier in this paper, businesses are concerned about having to compete with goods that, for various reasons, enter Georgia without customs duties. A British company has recently been contracted to handle Georgia’s customs operations and train Georgian customs officials in proper procedures.

Accounting Reform

Many businesses do not have adequate books and records. Accounting software has only recently been introduced and is mostly being used by medium-sized business that can afford computers. Some local accounting and auditing firms have begun training the staffs of client firms to improve their accounting systems and prepare for conversion to the new international accounting standards. A principal motivation for these clients, and non-client SMEs who

seek assistance in this area, is that improved accounting records and financial reporting will better arm them against tax collectors who may attempt to mislead them about the amount of tax they owe. Another key motivation is that the improved reports and records will be more attractive to banks and potential investors.

Georgian Enterprise Accounting Reform (GEAR) Project. USAID has made significant improvements in the area of accounting policy reform through this and related projects. The GEAR project, implemented by a consortium led by the accounting firm Sibley International, has several key components designed to support the transition to full adoption of international accounting standards (IAS):

- firm-level conversion to new IAS chart of accounts;
- education, including training of companies, accountants, auditors, tax inspectors and university professors, as well as training of participants in internationally-recognized Association of Chartered Certified Accountants (ACCA) program; and
- preparation of course material and some instructors for the recently-formed Georgian Federation of Professional Accountants and Auditors (GFPAA), the professional body for the accounting and auditing profession which will, among other duties as a professional association, administer the training and examination process for GFPAA certification.

At present, the Entrepreneurs' Law exempts small businesses (defined as less than ten employees and sales under GEL 40,000 per year) from compliance with the new accounting standards.

Land Reform

Privatization of land: Although thousands of SMEs were privatized in recent years, the land under these and other privatized companies remained in Government control. USAID supported Georgian efforts to streamline the process of land privatization and registration through lobbying of Parliament. The land privatization process is underway and has been successful so far. The completion of this process will be a big step for SME development and the development of a real estate market in Georgia and for businesses' ability to use land as collateral for bank loans. The Deputy Registrar of the State Ministry of Land Management reported that ten mortgages have already been registered with his office. The next phase of assistance will focus on re-sales and mortgages.

Business Registration

Many businesses cite a bureaucratic business registration process in Georgia as a serious constraint to business development. This complaint is heard from microentrepreneurs seeking to move from the informal to the formal sector, as well as from small and medium-sized enterprises seeking to register new businesses.

To establish a business, one must go through the following procedures and collect the following information:

- Charter of the company drafted.
- Minutes of the board meeting, as well as sample of signature and application, must be presented to the local court.
- Court will register business.
- Business must go to Tax Department for registration.
- Business must go to Statistics Department for registration and obtain code number.
- Business must register at police station.

This process can take as long as six or eight months. There are also indications of five or six other somewhat official or unofficial steps, some seeking some sort of unrecorded fee to move the application process along. Many SMEs choose, instead, to hire a law firm -- at a cost of about US\$400 -- to handle the process for them. We've been told that this method can complete the entire process in four or five days.

Banking

Banking policy reform efforts supported by USAID in the areas of bank regulation and supervision, and central bank initiatives, will have a positive impact on SMEs. The increase in capital requirements for banks and the strengthened supervisory role of the central bank, among other improvements, will affect the safety and soundness of the financial system that will be available to serve SMEs. This will help to restore SME confidence in banks to the point where banks are able to attract more deposits from SMEs.

Other Initiatives

With donor support and/or encouragement, several initiatives, in the form of direct legislative development or local advocacy organizations, have commenced.

Draft Law of Georgia on Support of Small Enterprises: At the request of the Parliamentary Committee on Economic Policy Reforms, a USAID-funded legal consultant was asked to review this proposed draft law which the Committee is planning to submit to Parliament for its second hearing in May, 1999. The draft law involves the private sector, particularly small business support organizations and the international donor community, in developing the small enterprise sector. The draft law also creates a governmental Center for Development and Support of Small Enterprises, with a directing body partially composed of representative ministries and small business support organizations.

The legal consultant has made recommendations designed to enhance the role of the private sector in leading economic growth efforts, rather than allowing a backward slide into a familiar yet ineffective structure that would have economic growth efforts channeled through government entities, rather than private sector practitioners.

6.2 Findings

The policy reform efforts that have been supported by USAID and other donors are critical elements in Georgia's economic development. Much of the reforms and related improvements will have a positive impact on the operating environment for SMEs. Many of these results involve needed changes in existing, outdated policies or the establishment of new policies needed to support private sector-driven economic growth in Georgia. The multi-channeled approach by donors to key thinkers in the government is intended to have a

greater impact than having one representative of a donor committee serve as the “point person” for government contact. While great strides have been made in the policy area, much less success has been achieved in moving these new policies to the implementation stage, where effective, transparent regulations and guidelines would be introduced and enforced.

Efforts to introduce these and other needed reforms must continue to be supported -- by USAID and other donors – to provide a solid foundation for sustainable economic growth. For example, the introduction of international accounting standards, accompanied by improvement in the training of accountants and auditors, will have a positive impact on the quality of financial statements produced by businesses. These statements will improve entrepreneurs’ abilities to manage their companies and present accurate, as well as informative, financial data to financial institutions.

The next step in the policy reform process is to get the word out to SMEs and others who will benefit from the new policies, regulations and guidelines. As indicated elsewhere in this report, many SMEs report that they know little about the latest information about recent reforms and legislation. The GEAR project and several local accounting firms have made successful efforts to spread the word about recent accounting changes to clients and business that seek their advice but information of this nature needs to be disseminated to businesses throughout Georgia.

One local accounting firm emphasized that SMEs with current knowledge of tax and accounting regulations, combined with accurate and efficient accounting systems and financial statements, are better protected against being misled by a tax collector about the amount of tax they owe. Having this knowledge at their disposal will not eliminate SME vulnerability to abuse by rent-seeking tax collectors but it will reduce situations where the tax collector sets an arbitrary tax bill that has little to do with the earnings of the business.

SECTION 7 ADDITIONAL OBSERVATIONS AND FINDINGS

This section incorporates other observations and findings which were considered important, but did not quite belong in the previous sections.

7.1 Geographical Scope

As instructed in the scope of work, the Assessment Team did not limit its analysis to greater Tbilisi, but examined other key cities and regions of Georgia as well. The team visited Rustavi and Gori in Eastern Georgia, but mainly concentrated on the cities and towns of Western Georgia. Here, the team visited Kutaisi and surrounding areas, Zugdidi, Poti, and Batumi. In Eastern Georgia, the general conclusion was that while Gori and Rustavi do have significant economic problems, they are close enough geographically to Tbilisi to benefit from the various assistance providers based there.

We visited Zugdidi because of the large number of Internally Displaced Persons (IDPs) that have relocated there since the civil war. While one would expect this influx of additional inhabitants to be an extreme burden (est. 58,000 IDPs in Zugdidi), the Team members actually found Zugdidi to have a quite energetic local economy. Supposedly, this area was one of the most prosperous and business-minded in Georgia before the war, and this history seems to be part of the reason the town seems to be able to survive now. In addition, we were informed that in contrast to Tbilisi, most of the IDPs have family members in Zugdidi so they are not seen as burdensome strangers from Abkhazia, but as relatives who need a place to stay.

The coastal towns of Poti and Batumi have their own troubles, but our judgement is that these will most likely dissipate with the improvement of the port system and with the businesses that will eventually evolve around the ports (discussed in Section 7.3). In addition, tourism will help these towns to survive.

In our estimate, one area in great need of assistance is Kutaisi and its surrounding towns. This area is littered with huge, old, dilapidated factories that no longer are operative. While there are many qualified and well-educated inhabitants, because of the closing of these factories, they are now jobless and seeking direction. Some have gone into microenterprise-type businesses for themselves, but many still remained unemployed. The Imereti region has agriculture, as well as industry, and with modern technology, the agribusiness sector could become well established in the region. However, at the present time, the area is quite economically depressed.

7.2 Agribusiness

Agribusiness has traditionally been one of the important sectors in the Georgian economy. Currently, almost 50% of the population is employed in agriculture or agriculture-related business, and the sector accounts for nearly one-third of gross domestic product (GDP). Prior to independence, the Georgian agricultural sector was developed to supply fresh and processed vegetables, tea, wine, and citrus to the entire Soviet Union. These crops were cultivated on state-controlled collective farms using industrial farming techniques, processed in huge factories and then exported to other areas of the Soviet Union. Basic foodstuffs, such as grain, and livestock feed were largely imported from the other Soviet Republics.

Following independence in 1991, Georgia's market links with other former Soviet republics were ruptured. Traditional command-driven distribution systems disappeared. This left the country with agricultural specialization and production facilities inappropriate for the new market realities and resulted in serious repercussions throughout the sector. By the mid-1990s, the production of major horticultural products had by fallen to only 60% of 1980s levels and many processing facilities were closed creating widespread unemployment problem. This situation has caused a significant contraction in the overall agricultural sector. The net result is that Georgia is now a net importer of food.²⁶

Despite downward turn in performance, the agribusiness sector offers real opportunities for development. Agricultural land comprises 43% of the total land area in Georgia, amounting to some three million hectares. Due to the existence of various and favorable climatic zones plus relatively good soils, Georgia can produce and process a diverse range of crops. Certain zones are ideal for apples, pears, peaches and other stone fruits, and hazelnuts. The traditional wine industry has considerable potential for development. Dairy development holds great promise if it is organized and supported with necessary inputs: new breeds of cows; processing facilities; and refrigerated distribution channels. Meat and poultry processing has great potential as well. The tea industry presents more serious problems but may have a future in supplying NIS countries. In Georgia, there are substantial opportunities to develop local and export markets for domestically produced commodities.

Major Constraints to Agribusiness

Despite these opportunities, serious constraints do exist. These constraints are much the same as those affecting all businesses in Georgia: high taxes, competition from smuggled goods, difficulty in obtaining credit, lack of farm-business management skills, and access to wider markets. The high cost and uncertain availability of energy is often cited as a major problem by processors, especially in such energy dependents businesses like the tea industry. Poor transportation infrastructure hinders the distribution and collection of produce. Refrigeration is an essential complement of agribusiness and food processing sectors. The recent growth in use of controlled atmosphere storage for stone and pome fruits is an important step in extending the cool chain for high value products. Even with these new technologies in place, much of what is being produced is of too low quality to export. Farmers need regular supplies or good inputs and better varieties of livestock, plants and trees if the widespread export of unprocessed fruits and vegetables is to become a reality.

Inputs and Credit

Currently there are very few Georgian companies or organizations involved in the sale of essential agricultural inputs (fertilizers, seed, pesticides, herbicides, etc.). The main supplier is the Farmers Union, but this organization has limited the establishment of its outlets to the regional centers of the lowland farming areas. ACDI-VOCA has facilitated the import of agricultural inputs by promoting a venture between an American supplier and several Georgian partners.

ACDI-VOCA has also been instrumental in introducing new varieties of seeds and forming agricultural credit unions to provide loans to small farmers to purchase farm inputs. Future

²⁶ The extent of this dependence is exemplified by the fact that yogurt, one of the main foods in the Georgian diet, is made almost entirely from imported milk powder rather than from locally produced fresh milk.

programming priorities will include support of co-op development and marketing, provision of credit to private farmers unions, support to the livestock sector through improving the availability of animal feed and introduction of crop diversification strategies. All of these activities will continue to focus on farms of five to forty hectares in size. ACDI-VOCA's work seems to have an important demonstration effect that may attract other organizations and businesses into this important area input supplies.

Suggested Approaches

Any intervention in the agribusiness sector should probably begin with an assessment and prioritization of opportunities. From the initial data gathered from interviews with farmers and agribusiness entrepreneurs, the best opportunities for the fresh fruit market are in growing grapes, apples, pears, cherries, stone fruits of all kinds, strawberries, and new varieties which are not currently produced. An approach would set up demonstration farms of 10-50 hectares or more with new varieties. New varieties would be distributed to local farmers once they see the quality of the produce. The demonstration farms would feed into a series of packinghouses and cold stores where the fruit could be graded, branded, stored briefly and finally exported out of the region. High quality fruit and vegetables fetch strong margins, but new varieties are essential. As new varieties are planted, the processing of existing low-grade fruit can go forward. Old varieties might taste great but do not have the appearance and quality demanded in the fresh fruit market.²⁷

Viewing the agribusiness sector as a whole, linkages are weak or nonexistent between producers, service providers, processors, domestic wholesalers/distributors, and exporters. Priority should be given to increasing the capacity of the private agribusiness sector in Georgia to produce, package, and market a wide variety of demand-driven, value-added agricultural commodities. This will require a range of interventions at the firm level and working with different industry groups to develop the fine points of such a program. The sub-sector diagnostic studies will be an initial point of reference in identifying and prioritizing problems to be addressed.

In this value chain, the private sector suppliers of inputs and services to producers, such as agricultural credit, veterinary services, seed suppliers, nurseries and scientific pest management consultants need to be fostered. As mentioned, for development of agribusiness, new varieties of seed and genetic material are essential. ACDI-VOCA has made start in the supply of seed for maize, wheat and potatoes but more needs to be done especially in the areas of fruits, vegetables and livestock. New cattle breeds that are good for both beef and milk could be introduced as soon as possible. The privatization of veterinary services should be strongly encouraged. Pest management is another area in need of serious attention. Under the Soviets, the emphasis was on controlling epidemics with large amounts of pesticides. With changing market conditions and the difficulty and cost of procuring inputs, there is a need to manage pests according to science-based methods, using knowledge of insect lifecycles and ecology to attack pests at the right time using narrow spectrum chemicals or biological agents. Such approaches use fewer pesticides, reduce production costs and increase the value of the product in international markets. All of these support services are needed to create the necessary supporting infrastructure for agribusiness development.

²⁷ One entrepreneur estimated that one job can be created in the farming sector for each 0.6 of a hectare planted with new varieties under modern farming practices. The backward employment linkages of processing facilities should not be underestimated.

7.3 Transport

Because of its strategic geographical location, Georgia has the opportunity to take great advantage of transport and distribution opportunities and make this service sector a large contributor to economic growth. Access to the Black Sea through the two main ports of Poti and Batumi means that Georgia can provide transit for trade between Europe and the countries of Central Asia and the Caucasus. In addition, Georgia's proximity to Russia, Turkey, and other major countries to the south and east provides other opportunities to facilitate international trade. The fact that there was a more than 70% increase in freight turnover in 1998 compared to 1997 demonstrates the growth potential of transit trade.²⁸

Even though there are opportunities in the transportation sector and these are being focused on by the private and public sector, presently Georgia's poor infrastructure has prevented the transport sector from reaching its full potential. The roads of the country are in very poor condition from years of neglect, and this limits the number of vehicles that can pass through Georgia or even deliver directly to the market. Also, the amount of law enforcement on these roads is excessive and unnecessary. A driver is very likely to be pulled over needlessly several times during a short journey, with many of these stops resulting in bribes to local policemen. In addition, the port facilities of Poti and Batumi are not as modernized and efficient as most port cities. However, through rehabilitation and other technical improvements, these problems may be solved within the next few years.²⁹

The European Union has targeted the transportation sector as one of its highest priorities, particularly through the TRACECA (Europe-Transcaucasia-Central Asia road corridor) "Silk Road" project, which seeks to reestablish Georgia as the crucial link between European and Asian trade. This project, which has contributed over 60 million ECU (US\$70 million) in technical assistance and investments, is trying to improve both roads and railways in order to ease the link between the Georgian port cities and the other countries in the region. The project is also the main implementor in the improvement of Georgia's ports. The World Bank, EBRD, and other donors are also contributing to improving transportation through direct infrastructure improvements, work with government ministries involved with transport, and direct assistance to transport companies.

Besides freight transport, another excellent opportunity is the transport of natural resources, particularly oil and natural gas. Recently, the opening of the Supsa terminal has demonstrated Georgia's role in this area. This pipeline links the oil fields of the Caspian directly to the Black Sea, with the majority of the transit occurring in Georgia. The Supsa pipeline should directly provide employment for a number of Georgian citizens in addition to indirectly improving employment thorough all the industries that will arise to support the oil business. Many small and medium firms such as restaurants, hotels, and other services connected with transportation should all develop in the next few years.

7.4 Export Opportunities

Given the small Georgian population and land area, a significant business and economic strategy is to concentrate on exporting in those industries in which Georgia has a comparative

²⁸ Georgian Economic Trends, 1999, No.1, pg.29, Georgian-European Policy and Legal Advice Centre.

²⁹ According to a USAID study, the privatization of Poti port has the potential to create up to 21,000 jobs.

advantage. Historically, Georgia has exported agricultural products, specifically tea, wine, and fruits, largely to the CIS market. With the change from a command to a market economy, and disruptions created by the civil war, these markets have largely been lost.

There is an interest by SMEs in developing export markets, but with some exceptions,³⁰ the businesses seem to have no notion of how to pursue foreign contacts. The TACIS centers have made some contacts to European buyers, but the quality of production is generally below the standards expected within the European Union.

Instead of trying to develop distant markets in Europe and the United States, it seems more reasonable to look for markets closer to home, such as Russia, Ukraine, and the Central Asian countries where there are contacts that could be rekindled. Georgian products have had good reputations in these markets, and new efforts in marketing, advertising, and packaging could re-establish sales there.

7.5 Tourism

Because of Georgia's beautiful landscape and hospitable climate, tourism is considered to be another service sector that can contribute greatly to the economy. The country has hundreds of thermal springs and spas, beaches along the Black Sea coast, and the striking Caucasus Mountains for either hiking or skiing. There are also medieval churches and ancient historical ruins that would be of interest to many visitors.

Even though Georgia's natural resources are attractive, the infrastructure to support tourism as a major industry is weak. There are few hotels in the country, and a majority of the ones that do exist are deteriorated and in disrepair. The spas are also run-down, and many are inoperative. In addition, in many locations in Georgia, the water and electricity are still unreliable, and transportation is difficult. Until these problems are corrected, Georgia will have a difficult time attracting tourists.

Georgia should not however concentrate on just attracting Western tourists. Under the Soviet Union, Georgia received an average of 2-3 million tourists a year mostly from within the U.S.S.R, and the inhabitants of these now independent republics are familiar with the attractions Georgia has to offer. Georgia should also focus on the increasingly prosperous countries of Eastern Europe. In addition, the country could concentrate on the niche-markets, such as adventure travel or eco-tourism. These niche markets require less infrastructure and could build a base while other facilities are improved.

7.6 Gender Issues

The constraints and problems facing the entire SME sector in Georgia, in the Team's view, are so vast that it is hard to isolate factors that make it more difficult for women-owned businesses, rather than all small businesses, to operate.

A study completed in 1998 by UNDP Georgia is the major source of information in the country on gender issues as related to business. This study was based on a sample of 254 women in nine cities who were either operating businesses or who wished to start businesses.

³⁰ Assessment team members interviewed two firms in Zugdidi (privatized state-owned businesses that were largely owned by former managers) that were either selling all production (tea) in Russia, or were trying to establish old trade ties (for soda and beer production) in Ukraine.

Several of the conclusions closely parallel the Team's findings concerning SME businesses, for instance, women-owned businesses are financed largely from savings, getting loans from banks is very difficult, interest rates are prohibitive, and longer term loans are needed. The study also noted that women have little experience in business³¹. Women-owned businesses are usually on the smaller end of the SME range, thus are as much or more subject to the constraints that weigh more heavily on small rather than medium businesses.

The Team briefly visited with a Georgian NGO, Women in Business, which is seeking to expand its business creation and spin-off development work from Tbilisi to several regional cities. Its program was impressive and effective, a view echoed by UNDP. If USAID wishes to provide specific gender-related support in SME and microenterprise development it might be well served to support this project.

³¹ Discussions with women entrepreneurs seem to suggest that women may be more willing to acknowledge their weaknesses as managers than their male counterparts, and hold more positive attitudes toward business support organizations.

SECTION 8 RECOMMENDATIONS

The above analysis suggests that USAID's strategy to accelerate the development and growth of private enterprises in Georgia (as set out in the draft Strategic Plan 2000-2003) is addressing key SME issues. As the strategy indicates, considerable work has been done at the macroeconomic level, but it is time to bring the results of this work to the grassroots level. In this section, we offer recommendations on how the strategy can be implemented in light of our research findings.

1. Focus greatest attention on small and medium sized businesses, to start addressing the immediate need for job creation.

Any serious attempt at accelerating private sector development in Georgia at this time will require USAID to give priority to the development of small and medium businesses, productive enterprises that add value to locally produced goods, provide services, and create new employment. It has been demonstrated worldwide that job creation largely comes from growing small and medium size business. In Georgia, this will require intensive effort and investment in market development, and the start-up of new and newly privatized small and medium industries with strong backward and forward linkages. Processing, packaging, transport, and distribution to markets must be re-created and jump-started to get the channels flowing again. As noted in USAID's strategy for SME development in the Caucasus, "Capital now needs to find its way into productive enterprises that will create more jobs and spread the benefits of growth to more members of society. An entrepreneurial middle class is critical to creating the means for sustainable economic development".³²

Most of the recommendations of this assessment speak to the priority of developing firms, so that jobs can be created. An additional consideration is to focus efforts in those areas that do not appear to duplicate the work of other donors. In some cases there is a range of options for implementing recommendations. These options are not mutually exclusive, and some or all of them could simultaneously or consecutively be adopted.

2. Focus SME development efforts outside of Tbilisi, especially in western Georgia.

Despite having only 25% of the country's population, Tbilisi serves as the focal point for an overwhelming concentration of donor assistance programs. In order to ensure that economic development proceeds equitably throughout the country, USAID should focus its SME strategy outside of Tbilisi. In particular, it should examine Western Georgia as the region where it could have a significant impact in creating jobs and increasing income among some of Georgia's most poverty-stricken inhabitants. In the forthcoming World Bank report, "Georgia Poverty and Income Distribution," the Imereti region is ranked as the poorest region in the country. The closure of many state industries has left thousands unemployed. If USAID focused a large portion of its SME efforts in this region, it would be creating jobs for some of Georgia's poorest citizens.

Even though the region contains Georgia's second largest city, Kutaisi (250,000 people), most donors have not concentrated much of their efforts here, except for some humanitarian relief. A concerted focus in this area would also benefit many of the IDPs in Georgia who have settled in Zugdidi and surrounding areas.

³² Page 35, Management Systems International (March 1998) USAID SME strategy for Caucasus Region.

3. Address the credit and capital needs of SMEs, particularly for long term financing.

As is noted by all observers, there is a critical lack of finance in Georgia for the growth of SMEs. Funding is needed for all aspects of business growth including acquisition of fixed assets and working capital financing. While there is some short-term credit available in the market, there is critical need for longer term funding. Accordingly, we are suggesting several options to address this need.

Option 3.1 Establish an SME equity fund based in Kutaisi to provide equity and longer term financing coupled with “hands-on” management and marketing assistance.

The fund would actively seek out and assist Georgian business investments with the following characteristics:

- operating new productive enterprises, and re-started privatized industries
- potential for long-run viability and growth, including significant job creation within two or three years
- management with a willingness and interest in actively using market-oriented management practices

The fund would provide equity financing with “hands on” management of the enterprises, and would assume major responsibilities for advising on day-to-day management and market development. An approach of deep mentoring assistance would be the operating mode. In the process, Georgian managers will receive practical experience in operating companies in market-oriented ways.

While this initiative primarily contemplates equity investments, the fund could also provide term loans as appropriate. Short-term working capital would be leveraged through local banks. It is expected that the investments would be in the US \$50,000 - \$300,000 range. The fund’s exit strategy would most likely come through management buy-outs, but could also be sales of shares to private investors, or public offerings once the development of capital markets makes this latter mode a feasible option. Additionally, the fund might consider a compensation scheme based on a percentage of increased sales or profits.

The fund managers would determine the technical assistance needed by the individual businesses, including any day-to-day assistance. These managers would be free to access technical support provided through donor resources (CERMA, ABC centers, IESC), local commercial providers such as self-supporting BSCs, accounting and marketing firms, or foreign commercial sources.

We do not recommend limiting the types of companies that could be assisted by the fund, but we do encourage that the fund be based in Kutaisi, so that that region’s marginally operating industrial and agro-processing industries are likely to be the greatest beneficiaries of the fund.

The major limitation of a fund of this type is that numerically, only a small number of firms (perhaps forty or so) can be assisted, so there is little direct leverage for improving funding opportunities and management skills for a wide range of businesses. The benefits, however, are that these firms are expected to be the “winners”, thus should have a positive demonstration effect for other businesses, particularly those who form the forward and

backward linkages of the investee firms. Certainly there is great opportunity to train and develop the Georgian nationals who would be a part of the fund staff, and who would be expected to assume increasingly significant management roles over time. This fund will also provide an opportunity to mentor managers of Georgian investee companies. Further, such a fund would represent highly targeted assistance to Kutaisi and the surrounding region.

Another significant problem in establishing such a fund is the serious amount of funding required for capitalization. However, there are expressions of interest from IFC and EBRD in investing in such a fund, and this may be a good opportunity for a donor teaming. As currently envisioned, USAID would cover the operating costs of the fund.

Comparable funds established by SEAF³³ are already operating successfully in several other central and eastern European countries, and similar funds have recently been set up in Russia, so there is ample precedence for this intervention as a successful method of assisting SME growth. Further, this approach is endorsed by the USAID SME Caucasus strategy, which stresses the importance of venture capital-type funding in the ENI countries.³⁴ In fact, some movement has already been taken in this direction at the instigation of the Eurasia Foundation's Washington office, which commissioned a venture capital specialist to do a brief investigation of the feasibility of establishing a Georgian fund (and other funds in the NIS region). This white paper on this should be available sometime in June, 1999.

Note that a commercial venture capital fund, the Caucasus Fund, LLC, has been established and soon will be operating in the Caucasus region. This fund will eventually be capitalized at US\$92 million, including approximately 2:1 funding from the US Overseas Private Investment Corporation (OPIC). (At present just under US\$8 million has been raised from investors, thus qualifying for a match of about US\$15 million from OPIC.) This fund is looking at commercial ventures, including hotels in Tbilisi, and airline service among the three Caucasus countries. It is also looking at an agro-processing venture that will be selling fresh fruit into Russia, followed by canned and further processed products, and is presently seeking US Trade Development Agency (TDA) funding for a feasibility study. The fund principals have experience in organizing similar funds in Russia.

Note: The Caucasus Fund appears to be targeting a market of bigger, more immediately commercial, investments than the type of fund that we are recommending. We are enthusiastic about the development of the Caucasus Fund, however, because it will be bringing additional equity money and investment know-how to the region.

Option 3.2 Develop a leasing product to respond to long-term financing needs of SMEs.

As is noted at length elsewhere in this paper, long term financing for fixed asset acquisition is virtually non-existent in Georgia. Leasing mitigates some of the problems that are encountered in trying to do term lending, including:

- Funding – rather than being funded by non-existent deposits, leases would initially be funded by the equity capital of a leasing company set up for that purpose.

³³ Small Enterprise Assistance Funds, based in Washington, DC, was founded in 1989 by CARE as the CARE Small Business Assistance Corporation (CARESAC). It became SEAF in 1995 and is no longer a subsidiary of CARE.

³⁴ Page 3, Management Systems International (March 1998) USAID SME strategy for Caucasus Region.

- Collateral – the use of proceeds of leasing lines could be highly standardized (for instance, certain types of industrial equipment or vehicles) thus would be easier to value. Further, the leasing company would have an interest in developing a market for equipment re-sales, thus ensuring that assets acquired through lease had liquidation as well as operational value. There should also be some benefit in easing foreclosure procedures, since title to assets would remain with the lessor.
- Lower interest rate – this may or may not occur, depending on the nature of the leasing law (e.g., whether depreciation can be taken by the lessor, which gives the lessor an economic benefit that can be paid for through a lowered interest charge to the lessee) and the owners/investors in the leasing company. (For instance, a captive leasing company that only writes leases for a particular manufacturer’s equipment may accept a lower profit margin because the parent is realizing its profits through the sale of the equipment.)

At this point there is no leasing law in Georgia, although drafts have been circulating through the donor community.³⁵ In addition to supporting appropriate legislation, USAID should finance feasibility studies to target the best leasing opportunities. In terms of SME development, this is likely to be transportation equipment, and may be the way to address the need for better technology in industry, such as the need for packaging equipment in agro-processing. (Notice that there is likely to be a parallel general interest in the country in leasing automobiles, reflecting the desire for more and better consumer goods.) In this case the focus of the operation is more likely to be defined by the type of product leased than by a geographic orientation, but the feasibility study could highlight the leasing solutions that speak more to the fixed asset needs of businesses in western Georgia.

The IFC has indicated an interest in investing in a leasing company, and as with the equity fund proposal, there may be a good opportunity for a partnered project. Depending on the outcome of the feasibility studies, it may be useful to approach equipment manufacturers to gauge their interest. There may also be local bank interest in developing a leasing company.

USAID does not appear to have sponsored extensive leasing projects in the ENI region, thus has no proven record of success or failure in this particular type of financing.³⁶ This type of project, however, does follow on USAID’s historic strength in introducing imaginative lending and investment programs, which have frequently been the most significant demonstration models in the region.

Option 3.3 Continue targeted assistance to develop the banking and financial sector.

As discussed in the Financial Sector section of this report, there is no substitute for a robust banking system. Unfortunately, this simply takes time and experience to develop. While it is outside of the scope of this assessment to truly make recommendations in this area, we would strongly urge that work continue in developing banking regulation and supervisory procedures.

6. Postpone development of business service centers and additional development of management consulting capacity at this time.

³⁵ The local IFC representative indicated that the IFC was interested in getting such a law passed, but had not been able to find a “champion” in the parliament to shepherd through its passage.

³⁶ Opportunity International’s Nachala program, operated in Bulgaria in conjunction with the Bulgarian American Enterprise Fund, used leases rather than loan agreements because of eased legal requirements.

As noted in Section 5, TACIS has made a start in establishing six business service centers staffed with capable professionals. CERMA continues to provide excellent training for its consultants inside its client companies. Although the level of professional capacity can always be improved, currently there is little demand for non-financial services in the business community, unless such services are linked directly to financial assistance. Most Georgian entrepreneurs do not value business plans unless they result in a loan. Plans are more often seen as a ticket to obtain money than a strategic document setting out the steps to position one's company in the marketplace. The Soviet era has also generated a healthy skepticism for "plans" in general. They are almost synonymous with overstated political objectives that are seldom grounded in reality. Generally, business people are tired of training and advice. They are now seeking tangible immediate results. The need for business services often starkly differs from the demand for these services. But until demand increases, there is little incentive to increase the supply at this time. While USAID should continue to support the development of local SME services through using their services for particular projects, no further direct assistance in this area is warranted in the near term.

This is not to suggest at all that Georgian businesses do not need management assistance. We strongly believe that in-depth assistance is greatly needed by most Georgian firms. However, delivery of this assistance through the business centers in Georgia has been mostly superficial, and has not been able to change the strategic direction of the companies. A more hands-on, firm-level assistance is needed.

In lieu of support to traditional business support centers, the following options are recommended:

Option 4.1 Sponsor a new approach to business skills training.

As noted extensively in this report, there is a fundamental lack of market-oriented management skills in Georgia among SMEs. Moreover, there seems to be a widespread lack of awareness by businesses that this is a problem. Aspiring entrepreneurs are wary of training as many of them were well educated in the Soviet era. They are apt to resent the fact that others see them as not being qualified to do something they think they know how to do. Donor programs have oversold business plans, which are seen only as political documents to get credit, rather than a realistic approach to solving a problem or carrying out an activity. The result of these attitudes is little demand for business management training as has typically been delivered in the ENI region. The problem remains, however, that this sort of skills training is dearly needed for Georgian SMEs to develop and grow.

We are recommending that USAID sponsor a new style of training program, consisting of short, flexible, highly specific business topics that are demand-driven, and would effectively rekindle the demand for training. For instance, "What Your Banker Wants to Know", or "What German Investors Want to See" are much more likely to be well-received than yet another seminar on writing a business plan, because these topics offer solutions, rather than abstract techniques.³⁷

³⁷ The idea of these seminars is to present business topics in a dynamic manner that will appeal to business owners' needs. For instance, a presentation such as the one described above would emphasize the "why" and "how" questions that banks and investors need to have thoroughly answered, rather than iterating the information that is usually contained in a business plan.

Two major questions about such training which would require further consideration are (1) who would prepare and deliver the seminars, and (2) where and under whose sponsorship would the training take place. On the first point we see a great opportunity for the development and delivery of the material to also have a capacity-building effect in training development in Georgia, and would want to have a US business training contractor working closely with Georgian counterparts. The question would be whether the US firm should partner with an existing Georgian business school or training company, or whether it would be more effective to develop a new Georgian firm. We suggest that this consideration be addressed as a part a proposal process, rather than being resolved in advance.

The second major question is where such training would be presented. We suggest that training be prioritized for delivery in regions outside of Tbilisi, with priority given to Imereti region, with delivery elsewhere depending on the availability of funding. More important, though, is the question of who would be the local host. The most obvious partners for local sponsorship of training are the business centers and local chambers, and it is expected that these seminars would enhance their standing in the business community (and their financial strength). However, it would be critical that the local agency already be viewed favorably, or at least neutrally, by local businesses, or the training might not be accepted. In such a case, it would make more sense, although it would involve a lot more work, to independently present the seminar topics.

In addition to presenting useful, specific information in these seminars, these forums could serve the double purpose of encouraging interaction among local businesses. This could ultimately lead to the development of local business clubs (which could even form the basis of a future business association strategy), but in the short run would create a terrific networking opportunity to generate business among the participants.

Option 4.2 Create public awareness campaigns around critical business topics – Knowledge is Power.

One of the major problems of the Georgian SMEs, and of the wider public, is a lack of information on critical issues. For instance, businesses do not know how taxes are computed, and this makes them easy prey for myriad tax inspectors. Further, it appears that the tax inspectors either do not understand the tax calculations themselves, and/or are charged with collecting a certain amount of tax, essentially unrelated to the actual financial performance of firms. While other initiatives in this area should be undertaken by the government (such as discouraging bribe soliciting, and reducing the number of inspectors), a social marketing campaign that would make tax calculation transparent would make it much easier for businesses to reckon their tax liability. This would arm them with accurate information and better position them to deal with the tax authorities.³⁸

The essence of this task is an advertising and public relations function, and ideally there would be a branded source that offered simplified information in print, on television, and on radio³⁹, obtained both through purchase and donation of media space and time. Certainly tax calculation would be an appropriate initial topic for a campaign of this type. Several other topics such as customs calculations, new international accounting standards, and exporting

³⁸ Since the tax inspectors would also be seeing the same publicly distributed information, it is most likely that they would also point to it as authority.

³⁹ More elaborated versions of the same information would also be highly suitable topics for the training seminars also recommended in this paper.

procedures could be presented subsequently. While wide use of social marketing has not been used in SME development in the ENI region, there has been some well-received work in television programs on business training.

The Open Society of Georgia Foundation (Soros Foundation) has already indicated an interest in supporting this sort of public interest campaign.

Option 4.3 Explore feasibility of a new market development initiative for SMEs, especially in the food and beverage sectors.

Market development is one of the biggest needs for Georgia at this time, especially in the food and beverage sectors, where the country appears to have a competitive advantage. Under the Soviet era, Georgia developed without any clear market direction. Everything was production oriented. Once produced and processed, goods were distributed by the State. Now that these former channels have been severed, Georgia is faced with a mammoth task of re-creating new markets using demand-driven principles, which are little understood and appreciated. New markets are necessary to create the demand-pull for the development of the entire agricultural sector with all of its vast potential.

To address this problem, the team recommends USAID explore a new initiative in market development. The focus of this initiative should be on helping agribusiness and processing companies in key sub-sectors to create new markets for domestically grown products within Georgia (import substitution) as well as developing exports, primarily for countries of the former Soviet Union. Specific sub-sectors would be targeted such as apples, pears, grapes, peaches and other stone fruits. The production of these crops cannot be easily mechanized and will maximize employment in small farms. But emphasis should be given to value-added processing and packaging rather than production in the initial stages. Dairy development and the meat industry should also be investigated to see where the most effective value-added interventions could be made. Value-added means that Georgian producers need to move a greater percentage of their output up the chain from bulk raw material to semi-finished and to consumer-oriented retail packaging, with cost-competitive improvements in quality, grade, and consistency at each step along the way. Attention must be given to the suppliers of key production inputs such as seed, semen, hybrid root stock, integrated pest management, and veterinary services.

This will require a broad array of technical and managerial interventions at the firm level which might best be carried out in the context of a project, staffed with expatriate long term advisors and using professional PVO volunteers working with Georgian companies. Such a project would advise companies on developing new products, better packaging and more effective distribution channels. It would develop trade links in other CIS countries, sponsor trade fairs, and marketing trips, assist in the choice and acquisition of new processing technology and provide strategic advice on market development. The project could also enhance Georgian exposure to market opportunities through business tours in nearby countries. Fees should be charged but only on the basis of success, that is a percentage of increased sales as a result of the intervention.

The approach should probably provide direct assistance initially until the right Georgian partner organizations can be identified and developed in relation to longer-term sustainability objectives. The goal would be to create a viable service provider after the project. Such an initiative might be linked in some way to the ABC consulting centers and the new TACIS

project in export promotion. These and other options should be explored in the feasibility study.

Such an initiative could be linked with the above mentioned equity fund or developed in parallel depending upon design options and available funds. Greater integration of these elements would link, synergistically, the triple requirements of management, markets and money (finance) for the development and growth of high impact businesses, those with strong forward and backward linkages providing significant levels of employment creation.

5. Continue to encourage “islands of innovation” and emerging voluntary associations but postpone major association building initiatives.

Although voluntary associations represent important institutions in any market-oriented democratic society, the appreciation of these organizations in Georgia is still nascent at this time. There is little demand for associations among the general business community outside of Tbilisi unless such organizations deliver tangible benefits such as credit. There is a healthy skepticism of big initiatives, top-down modes of organizing and attempts to build new movements around charismatic individuals, perhaps a psychological vestige of the Soviet past. Most SMEs see little value in existing chambers of commerce and oppose the notion of any kind of mandatory membership as is currently being proposed by government, some chambers and a few donor organizations.

Association development is firmly linked to politics in contemporary Georgia. The Georgian Chamber of Commerce is strongly identified with government interests. The newly formed American Chamber of Commerce is identified with US commercial interests. Attempts to build new associations are likely to result in a new political party, as was the case of the recently formed Entrepreneurs’ Association. Any attempt to quickly build a broad-based business association would likely turn into a new political party.

The above is not meant to suggest that association development should be ignored. Rather, it suggests that association development should be viewed as an evolutionary process and supported with appropriate interventions at the right time in the right place. In this transition period, old style command oriented chambers built on mandatory models most definitely should be eschewed. Care must be taken not to align too closely with partisan groups but continue supporting “islands of innovation” through programs like those supported by the Eurasia Foundation. Institutional grants should be avoided in favor of small contracts and short-term project-related assistance to help new organizations develop services valued by members. The purpose should be to foster new thinking and approaches. Lobbying efforts should be supported but through multiple channels of influence using direct access to “new” thinkers in key positions of power both in the parliament and executive bureaucracy. Dialogue should be fostered but any attempt to build a unified chamber movement at this time should be avoided until the political situation is more stable and the demand for such activities becomes more widespread.

One possible exception to this rule is farmer credit cooperatives like those now being formed with ACDI-VOCA assistance. Demand-driven initiatives in specific sub-sectors should be looked for and supported, especially activities related to improving production of inputs to farmers producing commodities for agribusiness-processing investments discussed above. Sub-sector associations built around effective demand for tangible benefits may be the most appropriate ways of building the fledgling association movement in Georgia.

6. Continue support to existing microenterprise finance projects, and encourage expansion outside of Tbilisi.

The initiatives discussed above are targeted at job creation and increasing employment, largely outside of Tbilisi. Support to the microenterprise sector can assist in developing a related target: income generation for that part of the Georgian population that is regarded as the most at risk because of permanent job loss resulting from the economic upheaval in the country, or more specifically, because of personal status as an IDP, with displacement resulting from the civil war in Abkhazia.

The FINCA and Constanta appear to be well-disciplined programs that have found workable formulas of delivering credit, primarily to market trader microenterprises. We would recommend that the Mission continue its support of FINCA, and actively endorse funding currently being sought by Constanta through the USAID's Global Bureau and ENI Bureau. We would also suggest that USAID encourage further expansion of the programs to western Georgia, and additional experimentation in delivery, to meet microenterprise finance needs beyond the market traders which are presently the focus of both programs.

APPENDICES

Appendix A

Data on Registered Georgian Businesses

The statistics on the following pages give a general profile of businesses in Georgia, by size, sector and urban-town-rural distribution. The Georgian Opinion Research Business International (GORBI) recently obtained the data from the Government of Georgia State Department of Statistics. GORBI provided the Assessment Team with the tables as a part of its report on the focus groups. All of the information is believed to be up-to-date as of April 1999.

FOCUS GROUP CHARACTERISTICS

As a part of the Private Sector study, Georgian Opinion Research Business International (GORBI) was commissioned to conduct seven focus groups to determine the business problems of, and attitudes of, small businesses in Georgia. The tables below list the gender and position of each individual participant, the business sector for each business, and the date and city of each focus group.

For the purpose of distinguishing the business size of the participating businesses, each is designated as “small” and “medium”. For the purpose of these focus groups only, a small business is one that has fewer than ten full-time employees, and a medium business has ten to twenty full-time employees. Per the Government of Georgia definitions, these would be considered “very small” and “small” businesses respectively.

1 May 1999

Private Sector (Small Businesses - Kutaisi)

Gender	Sector	Position
Male	Construction	Vice-Director
Male	Confectionery	Director
Male	Marketing bureau	Director
Female	Social center	President
Female	Pharmacy	Accountant
Male	Petroleum Importer/Distributor	Director
Female	Bakery	Accountant
Male	Automobile accessory importer/trader	Director
Female	Textile industry	Director
Male	Social service center	Director of production
Female	Pharmaceutical controller	Vice-director

1 May 1999

Private Sector (Medium Businesses - Kutaisi)

Gender	Sector	Position
Male	Repair service	Vice Director
Male	Cigarette Distributor	Regional Representative
Female	Medical Service	Director
Male	Technical repair service	Owner
Male	Social service	Director
Male	Cultural events organizer	Director
Male	Bath/Sauna	Owner
Male	Individual repair service	Owner
Female	Clothing Shop	Owner
Male	Trading firm	Owner
Male	Individual repair service	Owner
Male	Trading firm	Owner

2 May 1999

Private Sector (Small Businesses - Batumi)

Gender	Sector	Position
Male	Trading	Director
Male	Research Institute	Head of department
Male	Confectionery	Shareholder
Male	Confectionery	Distributor
Male	Import/export	Accountant
Male	Importer	Owner
Male	Trade	Owner
Male	Pharmacy	Director
Male	Service/restaurant	Director
Male	Service/Bar	Vice Director
Male	Importer of constructing materials	Owner

2 May 1999

Private Sector (Medium Businesses - Batumi)

Gender	Sector	Position
Male	Hotel	Owner
Female	Pharmacy	Shareholder
Male	Beverage Factory (non-alcoholic and alcoholic drinks)	Manager
Male	Shipping Service	Director
Male	Import/trade	Director
Male	Importer of construction materials	Owner
Male	Diagnostic Medicine center	Director
Male	Construction Factory	Manager

4 May 1999

Private Sector (Small Businesses - Tbilisi)

Gender	Sector	Position
Female	Hotel	Manager
Male	Café-bar	Director
Male	Bakery	Owner
Male	Agro-processing industry	Owner
Male	Grocery Store	Owner
Male	Laboratory – Ulcer Vaccine Production	Owner
Male	Shop	Owner
Male	Furniture Factory	Owner
Male	Automobile Trade	Owner
Male	Apparel shop	Owner

4 May 1999

Private Sector (Medium Businesses - Tbilisi)

Gender	Sector	Position
Male	Restaurant	Director
Male	Construction materials production firm	Chief of Department
Male	Medical diagnosis center	Head
Male	Agricultural chemical production	Owner
Male	Import/export	Owner
Male	Trading firm	Owner
Male	Medical center	Commercial Director
Male	Import/export	Vice-Director

6 May 1999

Private Sector (Medium Businesses - Gori)

Gender	Sector	Position
Male	Construction materials mill	Owner
Male	Shop	Owner
Male	Construction firm	Chief accountant
Male	Shop	Owner
Male	Beer restaurant	Director
Male	Importer	Director
Male	Transportation	Director
Male	Petroleum distributor	Manager
Male	Trading/import	Director
Male	Chain of supermarkets	Co-owner

List of Individual Firms Interviewed ⁴⁰

Type of Business	Location	Size based on number of employees	Primary Constraint or Need Cited in Interview
Bakery	Tbilisi	Small	Harassment by tax and other government inspectors
Printing and Graphic Design	Tbilisi	Small	Needs new equipment but no long term financing is available
Pharmaceutical Manufacturer	Tbilisi	Small	Lack of long term financing for new product development
Television and Radio Station	Tbilisi	Large	High interest rates and need for longer-term finance.
Chemical and pharmaceutical manufacturer	Tbilisi	Very Small	Seeking joint venture partner to expand markets for innovative product developed in laboratory
Brake pad manufacturer	Kutaisi	Very Small	Needs equipment financing but interest rates are too high
Clothing manufacturer	Kutaisi	Large	Must develop new markets as competitive position is threatened by cheap imports.
Soft drink bottler/brewery	Zugdidi	Small	Needs credit at lower interest rates to expand into new markets
Tea Processor	Zugdidi	Medium	Disruption of former markets is major problem and high cost of energy
Hazelnut Processor	Zugdidi	Medium	Seeking foreign buyers and new markets
Poultry farm	Gubi	Small	Technical problems, does not understand the industry
Fish farm	Samtredia	Very Small	Tax rates too high
Building Materials/Stone Cutter	Kutaisi	Small	Wants seasonal grace period on interest payments. Current payment schedules doesn't fit cash flow cycle.
Winery	Vani	Medium	No demand for products outside local area
Investment company	Tbilisi	Medium	Land values are being depressed by government, unable obtains additional finance using land as collateral needed to expand companies invested in.
Dairy Processor	Tbilisi	Medium	Cheaper local supply of fresh milk. Factory imports milk powder for processing
Essential Oil Processor	Kutaisi	Small but now idle	Needs working capital at reasonable interest rates to re-start—loans only given to operating factories
Food Importer	Tbilisi	Medium	Harassment from customs officials
Fruit and Vegetable Canning	Kutaisi	Former large SOE but idle	Disruption of former markets. Oversized and outdated technology.
Meat Sausage Manufacturer	Kutaisi	Small	Competition from cheaper lower quality products coupled with low purchasing power of customers. High tax rates hurt competitiveness
Management Consulting firm	Tbilisi	Medium	Low purchasing power of customers, must go upscale
Guest House	Tbilisi	Very Small	Corruption at all levels

⁴⁰ The actual names of the businesses are not included to protect confidentiality of sensitive information.

List of Contacts: Persons Interviewed

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TBC Bank

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Deputy General Director
TBC Bank

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Director
TBC Bank - Kutaisi Branch

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Finance Director
TbilComBank

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Tbilcreditbank

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Georgia Chamber of Commerce and Industry
Horizonti Foundation
International Executive Service Corps
Open Society of Georgia Foundation
SMEDA
TBC Bank
Women in Business

Appendix F

Suggested Modifications to the Results Framework

Based on the findings of the SME sector assessment, several modifications should be made to the existing USAID private sector results framework if the Team's recommendations are accepted by the mission. While a full re-write of the results framework is beyond the scope of this assignment, the following points should be taken into account if and when the current draft is revised. The following changes are recommended:

1. Consolidate legal, regulatory and policy work under IR 1.3.1—Improved Policy, Legal and Operating Environment for Private Enterprise. Since this IR deals primarily with the policy environment, all the existing activities in land reform, banking reform, tax and accounting reform fit nicely under this category. A new activity under this IR is also recommended: a social marketing campaign aimed at creating greater transparency and public knowledge of these policies and regulations. The dissemination and public awareness of USAID's sponsored policy work should be a part of this IR.
2. A new IR, 1.3.2, is proposed—Stronger demand-driven institutions and organizations serving the business community. This IR emphasizes the need for USAID to both create demand for market-oriented approaches in business services providers and voluntary business associations, as well as build on local initiatives, which are demand-driven. Premature organizing efforts will probably turn political and fail to be effective. Fostering demand-based organizations takes time and should be pursued, but with caution. It cannot be forced before the time is right. The approach should be to work first to create demand and then support the work of self-organizing efforts that have responded to the new impulse on their own initiative.
3. The third IR, 1.3.3, requires little if any modification in the area of micro finance. The development of new leasing products is a addition but can be incorporated under this IR.
4. The fourth IR, 1.3.4, Start-up and Growth of High Impact SMEs, places firm level assistance in a more prominent position in the newly proposed strategic framework. Unlike some approaches to firm level assistance, our approach emphasizes bringing money, markets and management to bear on the problems of firms. The Team concludes that only such a three-pronged approach will bear fruit in helping small and medium firms overcome the obstacles and develop quickly in the Georgian environment. Under this IR, is the establishing of a SME equity fund linking financing with in-depth technical assistance. In assisting SMEs, the entire problem of market creation must also be squarely addressed if firms are to grow rapidly and create new jobs.
5. A final point concerns the need for management training. We have noted in the body of the report that the demand for such training is minimal. Nevertheless, the need is real. New approaches should be tested building on Georgians healthy skepticism for planning and their particular desire to see practical results. Training of course should only be demand driven (fee-based). Changing attitudes (old-style mentality) and

building skills is required across all the Intermediate Result areas, and therefore has been treated as a crosscutting theme.